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DIPLOMOVÁ PRÁCE

Why Are They Only Slowly Picking Up?
Low Level of Cross Border Mergers and Acquisitions in EU Banking Sector

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Academic year: 2006

Prohlášení

Prohlašuji, že jsem diplomovou práci vypracoval samostatně a použil pouze uvedené prameny a literaturu

V Praze dne podpis studenta

1 Abstract

Within last decades, significant measures have been taken to create an integrated market for financial institutions as it is widely acknowledged that this leads to the ultimate goal of the European Union, creating a Single European Market. However a unprecedented wave of mergers and acquisitions (M&As) in the 1990s, had primarily of domestic nature. Hence, this thesis attempts to uncover which factors caused low cross-border activity. The first two parts of this thesis examine the macro-level, concluding that national interests and a fragmented supervisory infrastructure held financial integration back. The third part of the thesis looks at the micro-level, analyzing the ex-ante and ex-post stage of M&As. It concludes that firms seem to favor domestic transactions because synergies are more obvious and easier to extract, the fragmentation of Europe's financial industry offers substantial opportunities in the home markets, and attempting to grow to a size also needs to be accomplished in one (domestic) market. The last part of the thesis studies two cases of recent cross-border M&As, respectively Nordea and HSBC.

V poslední desetiletích byla přijata významná opatření za účelem vytvoření společného finančního trhu, který je považován za významný postupný krok pro vytvoření jednoho společného trhu v rámci Evropské Unie. Paradoxně, bezprecedentní vlna fúzí a akvizic v devadesátých letech měla primárně národních charakter. Tato práce si klade za cíl odhalit faktory vedoucí k relativně malé mezinárodní aktivitě fůzí a akvizic. V prvních dvou částech jsem se zaměřil na makro úroveň a došel k závěru, že národní zájmy a nejednotný dohled byly hlavní důvody pro pomalejší integraci. V třetí části jsem se zaměřil na ex-ante a ex-post stádia fúzí a akvizic a vyvodil, že firmy preferují domácí transakce, protože potenciální synergie jsou snáze dosažitelné, fragmentace jednotlivých domácích trhů nabízí řadu akvizičních příležitostí a velikost 'too big to fail' je také jednodušeji dosažitelná na lokálním trhu. V poslední části studuji dva aktuální případy mezinárodních akvizic.

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Thesis

Financial industry is one of the driving forces of economy, and M&A activity is often in multi billion terms. Appealing prospects in further consolidation attracted my attention and therefore aim of my master thesis will be assessment of activity in area of cross border mergers and acquisitions. The overall research question could be formulated as: What factors restrain wider cross-border M&A activity in Europe's banking industry?

This high level question will be further drilled down into particular subquestions. To answer my research question I will apply both quantitative and qualitative methods. My aim is not to write a pure statistical thesis therefore, the quantitative method and the accompanied numerical data will be merely used to support my conclusion, as I don't intend to perform statistical tests. The main research method will be therefore of qualitative nature which I find most suitable for gaining an understanding about the marginal use cross-border transactions.

Structure of my envisioned thesis will follow these dimensions: i) Europe's Financial Market Infrastructure assesemt, ii) Consolidation Activity in Europe, iii) Motives for M&A's, iv) Case Studies – here I plan to examine Nordea and HSBC – CCF cases.

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2 Introduction

The European Council at Lisbon[1] set the key strategic goal for the EU to become by 2010 *'the most competitive and dynamic knowledge-based economy in the world'*. One crucial element to achieve this goal is an integrated financial market, which can act as a catalyst for growth across all sectors of the economy and rival the North American capital market in terms of its depth, liquidity, and flexibility.

An assumption behind an integrated financial market is that cross-border competition fosters efficient, low-cost banking by allowing more efficient banks to move across borders and compete with less-efficient banks that were formerly protected by their nation's borders. This competition forces the inefficient banks either to improve or to leave the market, driving prices closer to marginal costs.[2]

Economic theory and empirical findings support this idea, suggesting that the integration and development of financial markets is likely to contribute to economic growth by removing frictions and barriers to exchange, thereby allowing the allocation of capital to be more efficient. Industry-level studies like that of Jayaratne and Strahan (1996) show that financial development causes economic growth, and Giannetti *et al.* (2002) suggests that the European manufacturing industry would grow up to 1 percent faster if financial markets across the Community developed to US levels. Even the most critical evaluations of the potential gains from establishing an integrated market in financial services expect considerable benefits.[3]

In the past two decades significant milestones where ratified towards setting a level playing field that encourages the integration of Europe's financial markets. The Single Market, the Monetary Union, and the growing internal and external competition, triggered by developments in IT, overcapacity, globalization, and increased shareholder pressure for financial performance[4], have led to a massive and unprecedented consolidation in Europe. One of the most notable features of

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[1] Meeting held in Lisbon from the 23rd – 24th of March, 2000

[2] Berger, A. N. and Smith, D. C. "Global integration in the banking industry", *Federal Reserve Bulletin*, November issue, 2003

[3] A working paper from the Commission of the European Communities, May 26, 2003, "Tracking EU Financial Integration" estimates that if the EU manufacturing industry was given access to a financial market similar to that of the US, the output of this sector would increase at an annual rate of 0.8 to 1.0%. Even though the additional growth this could generate would be unevenly distributed among Member States depending on the development of their financial sector and the existing financing possibilities for manufacturing firms, all would gain. London Economics estimates that pooling the present regional bond and equity markets would move the EU to a new equilibrium point characterized by higher GDP (1.1%) and employment (0.5%). These estimates relate only to the macroeconomic benefits that can be expected to flow from removing static inefficiencies (wider bid-offer/credit spreads and adverse price impacts) associated with the fragmentation of European equity and corporate bond markets.

[4] Nicolo, G.D. Batholomew, P. Zaman, J. and Zephirin, M. "Bank consolidation, internationalization, and conglomeration: trends and implications for financial risk", *IMF Working Paper* WP/03/158, July 2003

this industry roll-up was the ongoing consolidation of banks that reshaped Europe's financial landscape (Group of Ten, 2001).

Surprisingly though, this consolidation wave has been in all industry segments dominated by domestic mergers and acquisitions (M&A). Also Europe's financial markets, which received most attention in terms of integration enhancing policies, saw only marginal cross-border activity. In fact was cross-border M&A within the EU far less common in the financial sector than in other sectors of the economy. To that comes that the few cross-border deals in the financial industry that were recorded mainly involved at least one institution from outside Europe, thereby no trend towards wider cross-border M&As within Europe could be discerned.[5] This observation was particularly disappointing, as it was believed that if banks were able to take full advantage of the freedoms that exist for them in a single European market, then they would be able to contribute more fully to the EU's wider Lisbon Agenda goals of competitiveness and growth.[6]

3 Research Objective

The unprecedented M&A activity in Europe in the 1990s and the extensive measures to support widespread cross-border activity in Europe's financial industry on the one hand, and the marginal effect on intra-European consolidation on the other hand, caught my interest. Interestingly, there are various theoretical and empirical studies on the causes and consequences of domestic mergers, though significantly less is known about cross-border mergers, especially those involving EU partners.[7] This apparent gap in the academic literature motivated me to look into this matter and research what the major causes of the marginal cross-border activity were.

The overall research question, which I will attempt to answer in this thesis, is therefore the following:

- What factors restrain wider cross-border M&A activity in Europe's banking industry?

To address this research question systematically, my analysis will be based on a number of sub-questions that will help me to get a better understanding of the industry, which seems necessary to analyze and answer the research question properly. I will therefore start by reviewing the various policies undertaken by the EU that were supposed to enhance the integration of Europe's financial

[5] "Mergers and acquisitions involving the EU banking industry – facts and implications", *ECB Press Release*, December 20, 2000

[6] "Cross-border mergers and acquisitions in the banking sector: follow-up to Scheveningen informal ECOFIN", European Commission - DG Internal Market and Services - Banking Advisory Committee, December 2004

[7] Ietto-Gillies, G. Meschi, M., Simonetti, R. "Cross-border mergers and acquisitions: patterns in the EU and effects", available at www.merit.unimaas.nl/tser/teis021.pdf

markets. In addition, I will analyze how far integration has progressed and outline inhibiting factors to wider integration. Furthermore, I intent to review how these measures have affected the financial industry, i.e. did they causes greater cross-border activity within the EU. Hence, the first sub-question that I will address is the following:

- How far have Europe's regulatory- and supervisory institutions progressed in terms of creating an integrated European financial market and how has this affected the consolidation activity of Europe's financial institutions?

While the first sub-question was primarily concerned with reviewing the progress of financial integration and its impact on the consolidation activity from a macro-level perspective, I will in the second sub-question turn to the micro-level and investigate the ex-ante stage of M&As and outline what the motivating factors and influences are that let firms engage in M&As. Followed by that, I will review the ex-post stage of M&As and review the occurrences subsequent to a transaction in terms of integration and performance in the light of the high failure rates in delivering the promises of the ex-ante stage. The second question is therefore the following:

- With empirical evidence indicating that the majority of all M&A's do not live up to the announced promises, what is the motivation for firms to engage in mergers and acquisitions, what causes the high failure rate, and is there a difference in domestic versus cross-border transactions in terms of performance?

Having analyzed financial integration and consolidation from both the macro-level and the micro-level, I will use these findings and gained insights to apply them in a specific case study of two recent cross-border transactions in Europe's banking industry. The purpose of the two case studies is to complement the general causes and consequences of consolidation in Europe with the specific experience of these two cases. In addition, the review of these two cases will help to explain why one transaction appeared to be more successful than the other. Hence, the third and final sub-question in this thesis is the following:

- Analyzing two of the most spectacular cross-border transactions of recent years, notably between Merita, Nordbanken, Unidanmark and Christiannia on the one hand, and HSBC and CCF on the other hand, is there an explanation as to why one appears to have performed more successfully than the other?

The more general insights I gained from researching and answering the first two sub-questions are therefore complemented by the more specific insights of the two case studies, which should permit me to give a sound and qualified answer to the overall research question.
The value and originality of my study lies in the attempt, which to my knowledge has not done

before, to analyze the marginal cross-border transaction in Europe's financial industry from both a holistic angle by reviewing various streams of literature on the macro- and micro perspective of consolidation. In addition, I complement the analysis with the insights gained from two specific and highly relevant case studies on EU cross-border transactions.

4 Delimitation

Due to the broad scope of my study various streams of literature exists, that focus on many specific issues e.g. financial regulation, cultural differences in M&A, financial performance etc. Parallel to that some issues have received a great deal of attention, e.g. financial integration in the EU, resulting in a vast body of literature, while information is scarce on issues that e.g. attempt to review and explain cross-border consolidation within the EU banking sector. As the intention of this thesis is not to analyze one specific issue in depth but to analyze the various angles, i.e. the macro and micro perspective, as well as two case studies, that can help to shed light on the research question, I have reviewed a vast body of literature, which was freely accessible.
Particularly in respect to numerical data on M&As it would have been advantageous to have access to e.g. Thompson Financial to obtain the latest statistics on EU cross-border M&As, though this proved impossible without subscribing to their services. In addition, I was unfortunately not able to obtain active co-operation from the two respective corporations dealt with in the case study, due to time-constraints from their side. Obviously, first-hand information through e.g. interviews or internal material would have been of great value to the information depth and analysis.
Nevertheless, through using LexisNexis Professional extensively, I reviewed numerous articles from major global newspapers and magazines on the respective cases of the last 5-8 years, and through that, I believe to have gained a good understanding of the developments as well as an objective and broad assessment of the respective cases.
Throughout the thesis I use the terms 'Europe', 'EU' when referring to the 15 European countries that were part of the EU prior to May 1, 2004, or 'the old Europe' to quote Donald Rumsfeld, Secretary of Defense. The terms 'euro-area', 'euro-zone' refer more specifically to the EU countries that are members of the European Monetary Union. Although using the term 'financial institutions' frequently in this thesis, the emphasis of this study is on the banking sector, not least due to the vast literature that focuses on this segment.

5 Methodology and Structure

In this section, I will introduce the research approach of this study that I choose to answer the above stated questions. In addition, I will explain the structure of the thesis, and define some of the theoretical concepts that are used throughout the thesis related to consolidation and M&A.

5.1 Methodology

Generally, one distinguishes between two main research methods, the quantitative approach and the qualitative approach. The *quantitative* method is focusing on statistical analysis of collected numerical data and attempts to find answers for questions concerned with 'how much', 'how many', 'to what extent' etc. The *qualitative* method is not concerned on numbers but on words and observations, or as Zikmund (2000) puts it "any source of information may be informally investigated to clarify which qualities or characteristics are associated with an object, situation, or issue." Compared to quantitative research, qualitative research is concerned with finding answers to questions that begin with 'why and how'. Which method appears to be the most applicable varies depending on the research question as well as the data available. To answer my research question I apply both quantitative and qualitative methods. Nevertheless, the quantitative method and the accompanied numerical data is merely used to support my conclusion, as I do not perform statistical tests. The main research method is therefore of qualitative nature as it is most suitable for gaining an understanding about the marginal use cross-border transactions.

Zikmund (2000) furthermore identifies three broad research approaches, the exploratory, the descriptive, and the explanatory approach. While *exploratory* research is conducted to clarify ambiguous problems and define the nature of a problem for example with the help of case studies, the *descriptive* research aims at examining and describing characteristics of a population or phenomenon in detail and is based on previous understanding of the nature of the research problem. *Explanatory* research is conducted to identify cause-and-effect relationships among variables by for example testing different hypotheses.

For my research, I will make use of both the exploratory approach and the descriptive approach. In the first three major parts of my thesis, the descriptive approach is made use of when reviewing the developments in the EU in terms of regulatory and supervisory developments. The exploratory approach is applied in the last section of the thesis, as it is thought of complementing the descriptive review by "obtaining information from one or a few situations that are similar to the researcher's problem situation" (Zikmund, 2000). Yin (1989) compares cases studies to other research methods and concludes: "case studies are the preferred strategy when 'how' or 'why' questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real-life context".

According to e.g. Kam (1990) there are two ways to form theory, the deductive approach and the inductive approach. The *deductive* method is characterized by the fact that premises are intended to provide support for the conclusion that is so strong that, if the premises are true, it would be impossible for the conclusion to be false. An example of the deductive approach is the verification of existing theories by empirical evidence. In the *inductive* approach, the premises are intended only to be so strong that, if they are true, then it is unlikely that the conclusion is false. Here an example could be the formulation of a new theory, based on sound findings.

As my research objective is to attempt finding possible explanations for the marginal number of cross-border transactions that occurred in Europe despite the encouraging framework conditions, my approach can be termed inductive as my analysis of the framework conditions and the exploratory research of the case studies will lead to a possible explanation.

There are three major criteria for evaluating scientific research, reliability, validity, and sensitivity (Zikmund, 2000), though just the former seems applicable to the nature of this study. Broadly defined, *reliability* is the degree to which measures are free from error and therefore yield consistent results. An investigation with good reliability is not affected by who conducts it or by the surroundings, and should give the same results if other researchers are conducting the same analysis using the same sources. For my research I relied on sources from both academic journals and non-academic origin, such as the European Commission, the European Central Bank, the OECD, the Bank of International Settlements etc. that all have dealt, directly or indirectly, with my research question and the affected industry. Although I am aware that relying on secondary information yields several shortcomings, not least because "they are not designed specifically to meet the researcher's need"[8], I believe to have marginalized these shortcomings by using recognized and much-respected sources, and am therefore convinced of the reliability of my study.

5.2 Concepts and Definitions of M&As

In general, consolidation causes the resources of the industry becoming more tightly controlled, because either the number of key firms is smaller or the rivalry between firms is reduced. Consolidation may result from combinations of existing firms, growth among leading firms, or industry exit of weaker institutions.

Broadly speaking there are two alternatives for firms combining with each other, either through M&As or through joint ventures and strategic alliances. Each has its strengths and weaknesses and may be particularly appropriate in certain situations. This thesis is particularly concerned with the

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[8] Zikmund, W. G. "Business research methods", *The Dryden Press*, 6th edition, 2000

former of the two alternatives as they represent the primary method of consolidation employed by firms (Group of Ten, 2001). Mergers and acquisitions can broadly be defined to include mergers, acquisitions, tender offers, purchases of stakes, divestures, and leveraged buyouts - the most common type is though the acquisition (Smith and Walter, 2003).

An acquisition is defined by the UNCTAD (2000) as a transaction where a company (acquirer) takes over another one (target) and clearly becomes the new owner. From a legal point of view, the target company ceases to exist and the acquirer "swallows" the business, while stock of the acquirer continues to be traded. Similarly, a transaction that happens when two firms, often about the same size, agree to go forward as a new single entity rather than remain separately owned and operated is called a merger - often this is also referred to as a "merger of equals".[9]

Acquisitions can, depending on the degree of ownership, be sub-divided into three categories: 1) full asset acquisition, 2) majority acquisition, and 3) partial (or minority) acquisition. As this thesis focuses on the developments in the EU, it might be interesting to point out that particularly the third category is a very European modus operandi, being almost three times as prevalent in transactions involving non-UK European corporations.[10] A gradual commitment to a final arrangement as so far often favored by European companies, as it appears cheaper and reversible. Lengthy EU liaisons and courtships, or 'trial marriages', may lead to full M&A's that prove to be more lasting and beneficial than some of the more impulsive, opportunistic US acquisitions that often appear to fail in delivering expected benefits (Smith and Walter, (2003)).

Depending on the geographic scope, mergers and acquisitions can be categorized into three broad categories: 1) Inter-EU M&A's where the acquirer and the target origin from the same country, 2) Intra-EU M&A's where the acquirer and the target are origin not from the same country but still are located in the EU, and 3) EU-Global M&A's where the acquirer is a company from an EU country while the target is from a country outside the EU or vice versa (Ietto-Gillies et al). While the inter-EU transaction is by definition a purely domestic deal, both the Intra-EU and the EU-Global M&A's are cross-border transactions.

Furthermore, depending on the scope of business of the acquirer and the target, lets the UNCTAD distinguish between three types of transactions, 1) the horizontal M&A, which refers to a situation

[9] In practice, however, actual mergers of equals do not happen very often as one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, using the term "merger" instead allows dealmakers and top managers to make the takeover more palatable In other words, the real difference between mergers and acquisitions lie in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

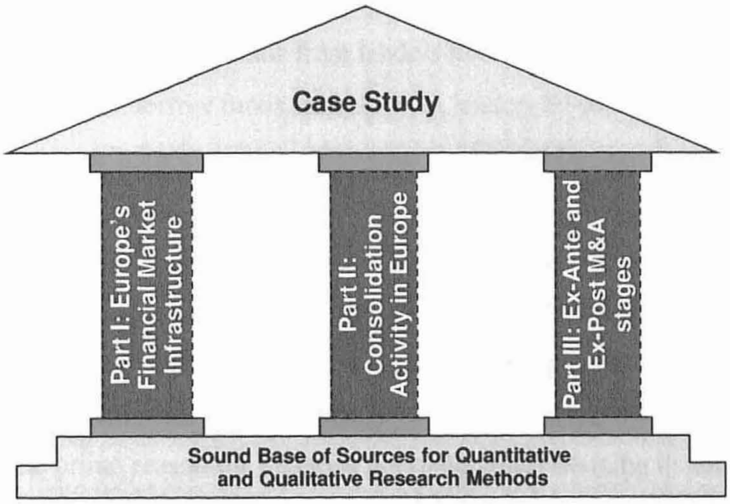
[10] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

in which the merger or acquisition takes place between firms operating in the same industry, 2) the vertical M&A that involves firms operating at different stages of a sequential production process, and 3) the conglomerate M&A which is a transaction between firms that are not related to each other in terms of industrial output.[11]

5.3 Structure

To answer the research question I will follow Figure 1, which outlines the structure of this thesis. The first two major parts of this thesis will look at the macro-level, reviewing the developments in Europe's financial market from a regulatory perspective followed by an analysis of the consolidation activity that has taken place in recent years. Subsequently, I turn to the micro-level in the third part, where I analyze the ex-ante and ex-post processes in M&A transactions. In the final part of the thesis will use my findings from the macro- and micro-level and complement it with the case-specific insights from two of the first and most spectacular European cross-border deals in banking.

Figure 1: Structure of the thesis



Source: Own illustration

6 Part 1 – Europe's Financial Market Infrastructure

I will begin this section by briefly explaining what a financial market is and what participants are

[11] Several other classifications exist, e.g. Bower (2001) who provides a more elaborate typology which differentiates between five different types of M&A's, namely; 1) the overcapacity M&A, 2) the geographic roll-up M&A, 3) the product or market extension M&A, 4) the M&A as R&D, and 5) the industry convergence M&A.

operating in it. Due to the special characteristics of financial markets, I will then outline why it is necessary to have regulatory and supervisory institutions and what their respective areas of responsibility are.

This preliminary section will then be followed by a review of how the financial market evolved in Europe over the past two decades by discussing some of the major policies taken to align regulatory and supervisory structures among member states. At last, I will review the progress of financial market integration within Europe by reviewing and discussing several indicators of both quantitative and qualitative nature to conclude eventually whether integration of Europe's financial market has succeeded.

6.1 What are Financial Markets?

A financial market can broadly be defined as an economic space wherein operators of various kinds – banks, mutual funds, insurance companies, pension funds, etc. – offer financial instruments and services (Di Girogio and Di Noia, 2001). Its essential economic function is to channel funds from households, firms, and governments that have saved surplus funds, to those that are in need of funds because they wish to spend more than they currently have (Mishkin, 2004).

The channeling of funds from lenders to borrowers can happen in two ways. In *direct* financing, borrowers borrow funds directly from lenders by selling them securities that are claims on the borrower's future income or assets. As this can be very time consuming and risky, an alternative and today very common way is to leave this task to financial intermediaries that stand between the lender and the borrower, hence the name *indirect* financing. Indirect financing or financial intermediation, is today the primary route for moving funds from lender to borrowers, and is generally a far more important source of financing than the securities markets, also for corporations (Mishkin, 2004).

The prime reason for financial intermediation obtaining its importance and influence in today's economy is that they resolve the information conflict faced by borrowers and generally enjoy substantial economies of scale in processing and analyzing information. In addition, they can provide their customers with liquidity services that make it easier and economically more viable for customers to conduct transactions. This specialization and expertise allows them to more efficiently and successfully screen out bad credit risks from good one, thereby reducing losses due to adverse selection.[12] In addition, financial intermediaries have developed an expertise in monitoring the parties they lend to, thus reducing the losses due to moral hazard.[13] Another aspect of financial intermediaries is that they help investors to reduce their exposure to risk by creating and selling assets with risk characteristics that individuals are comfortable with. Furthermore, their often-large size[14] allows them to take advantage of their scale, reducing the transaction costs per dollar of transaction (Mishkin, 2004) making thereby the services of financial intermediaries more attractive and accessible to a larger pool of customers.

6.1.1 Participants of Financial Markets

The financial intermediaries operating in financial markets can be classified into four broad categories, namely 1) commercial banks, 2) insurance firms, 3) securities companies, and 4) asset management firms. Depending on the purpose, different and finer subdivisions are possible e.g. by risk characteristics, the maturity of their assets or liabilities, and the particular services they provide. For the purpose of this thesis I will though adopt the above categorization, and introduce the four respective categories briefly.

6.1.2 Commercial Banking

Probably the most publicly visible financial intermediary, as almost everybody has a bank account, is the commercial banking sector, which also is the biggest sector in terms of people employed. The clientele of commercial banks is very diverse, providing services to individuals, small businesses and large organizations and institutions. As the needs and characteristics of individual customers differ greatly from that of large-scale customers such as corporations and institutions, the terms of accepting demand and other deposits as well as making commercial and consumer loans are different. Therefore, commercial banks often segment their costumers to serve these different needs accordingly. Alternatively, some commercial banks specialize entirely on one segment e.g. small private banks focusing on very wealthy customers.

Because commercial banks are such an important component of the money supply for a countries

[12] Asymmetric information occurs when a borrower has better information about the potential returns and risk associated with the investment project for which funds are earmarked than the lender does. Adverse selection is the problem created by asymmetric information before the transaction occurs. Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome – the bad credit risks – are the ones who most actively seek out a loan and are thus most likely to be selected.

[13] Moral hazard is the problem created by asymmetric information after the transaction occurs. Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender's point of view, because they make it less likely that the loan will be paid back.

[14] 25 of the Worlds 100 largest corporations, ranked annually by the Financial Times are financial institutions, see "Financial Times Deutschland", May 26, 2004

economy, special attention is given to this group by the regulatory and governmental authorities to ensure a proper functioning and conduct (Mishkin, 2004).

6.1.3 Insurance

The second most popular financial intermediary category is the insurance segment, which is specialized in providing contingent promises by underwriting economic risks associated with death, illness, damage to or loss of property, and other exposure to loss. Similar to commercial banking, insurance companies are divided into two groups, life insurance and non-life insurance. The distinction between the two lies largely in the long-term risks that reside in life insurance compared with the short-term nature of most other insurance risk.

What is characteristic about non-life insurance, which includes social- and market insurance, is the fact that social insurances for events such as the loss of labor income and the basic amenities of life as a result of unemployment, disability and other medical problems, and natural disasters are almost exclusively run by public-government owned firms. The reason why private insurers usually do not provide this type of coverage is because: 1) losses are difficult, if not impossible to predict, 2) losses and the events that trigger them can be difficult to define precisely, 3) the insured is often able to withhold information important to the assessment of risk, and 4) the existence of insurance can alter the insured's behavior. Insurance provided by private insurers is more common in areas such as casualty and property where the problems listed above are less of a concern.

6.1.4 Asset Management

One reason that asset management recorded a considerable growth in recent years is due to the rapid aging of population. The share of savings invested in pension funds but also in the above-mentioned life insurance sector has increased significantly and is expected to increase further due to the inability of the public 'pay-as-you-go' pension schemes to supply adequate revenues in the future (Dermine, 1999).

Asset management is concerned with investing the pooled resources of individuals and firms into collective investment vehicles, consisting of a wide range of equity, debt, and derivative promises. The distinguishing characteristic of these vehicles is that they transform the underlying promises into an equity promise by the vehicle. That is, the ultimate risk inherent in the underlying investment portfolio is borne by the shareholders in the vehicle. Although there are many variations of collective investment vehicles around the world, most fall into one of the two main types: either open-end or closed-end mutual funds. Open-end funds issue new shares to the investing public to generate new investments and typically stand ready to buy back or redeem the shares at their net asset value. Closed-end funds issue a fixed number of shares only. The shareholders in a closed-end fund access the value of their investments by selling their shares on the market.

What distinguishes contractual savings institutions, such as insurance companies and mutual funds from commercial banking, is that they acquire funds at periodic intervals on a contractual basis. Thereby they can predict with reasonable accuracy how much they will have to pay out in benefits in the coming years, and hence they do not have to worry as much as depository institutions about losing funds (i.e. bank runs). As a result, the liquidity of assets is not as important a consideration for them as it is for depository institutions, and they tend to invest their funds primarily in long-term securities such as corporate bond, stocks, and mortgages.

6.1.5 Securities

The securities dealers (including investment banks, stock brokers, and other financial intermediaries that stand ready to buy or sell securities) gained significant popularity towards the end of the 1990s through the global stock market hype. Their business is to make markets in new securities by underwriting their issue and facilitating their distribution to individual and institutional investors. They make secondary markets in these securities by taking principal positions as buyers and sellers of existing securities. Securities dealers range from small firms specializing in single product lines to large diversified firms offering a broad range of services, including position-taking, brokering, margin lending to customers, investment banking services, money management, and research. Hence, these institutions can be viewed as specialists in providing liquidity services by in the same time reducing the search- and information costs involved for customers in determining the fair value of particular securities.

The above four categories of financial market participants are though often interrelated as in Europe the universal banking principle was and still is prevalent[15], allowing e.g. commercial banks to engage in a full range of securities activities in a direct way rather than through separately incorporated subsidiaries. In addition, the rapid developments in IT and the general growth in the size of banks due to consolidation, elaborated on in section 7.2, encouraged the spread of universal banks that combine both retail- and wholesale functions as well as simultaneously performing

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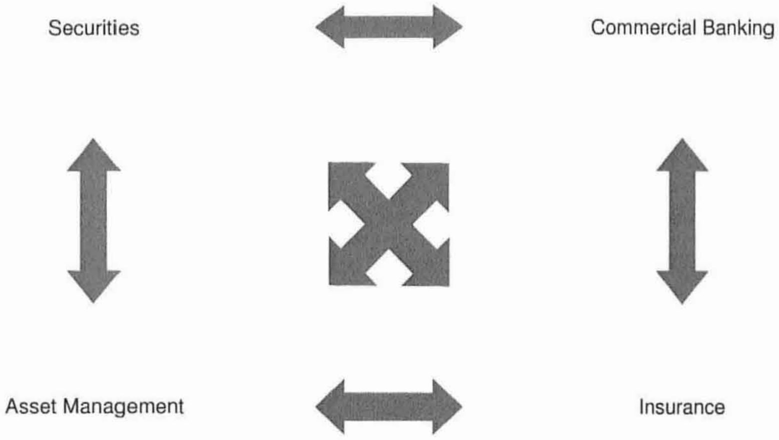
[15] Though was the UK an exception as it separated commercial banking from e.g. securities operations, similarly to the Glass-Steagall Act in the US, which the Gramm-Leach-Bliley Act of 1999 though abolished.

various or all of the four general activities.[16] This interrelatedness between basic financial market activities is well- illustrated in Figure 2 and does not only apply to commercial banks, although they are the most frequent examples, but to all financial institutions.

Figure 2: Overview of financial market participants and the overlapping of businesses



Source: adapted from Smith and Walter (2003)

Having introduced and given an overview of the main participants of financial markets, I will now explain why the financial services sector is tightly regulated and supervised.

6.2 Purpose of Regulation and Supervision

The financial services industry in general and banks in particular, represent the core of a countries economy.[17] Therefore, every country regulates its financial industry with the objective of maintaining a safe and sound banking system – one that is resistant to collapse and avoids contamination of the payment system and the credit allocation system (and therefore the real economy), yet without precluding the failure of institutions that are not competitively viable or are poorly managed.[18]

Financial regulators and supervisors have therefore the crucial tasks of identifying the 'bad' institutions at an early stage and either prevent them from trading by refusing authorization,

[16] Fazio, A. "Regulation and supervision in financial markets" Presentation the European Banking Congress 2004, Frankfurt, November 19, 2004

[17] The importance of a sound, well-regulated financial sector, of which the banking system is a crucial part, is sine qua non for macroeconomic stability and sustained growth, says for example IMF's Anne O. Krueger, "Banking needs of a global economy", at the Bankers Conference in New Delhi, India, on November 10, 2004 to be found at: http://www.imf.org/external/np/speeches/2004/111004.htm

[18] The main three major objectives of regulation are 1) to pursue macroeconomic and microeconomic stability, 2) ensure transparency in the market and of intermediaries, as well as protecting investors, and 3) to safeguard and promote competition in the financial intermediation sector (Di Giorgio and Di Noia, 2001).

improve their standards through regulation, or force them to close down. An economy that would not pursue regulation and supervision of its financial institutions would increase the likelihood for systemic risk, which is commonly known as the domino effect and refers to a situation where the failure of one financial institution triggers the collapse of others, e.g. through bank-runs, thereby putting the entire well-being of the economy at jeopardy. As Steil (1992) notes: "Systemic risk is the market version of acid rain; it may be produced in only one jurisdiction, but its effects know no boundaries."

The increasing interrelatedness of the four basic financial functions and the consequent increase in financial conglomerates illustrates, according to Morrison (2002), the potential that the chances for systemic risk have increased in recent years, highlighting furthermore the necessity of financial regulation and supervision.

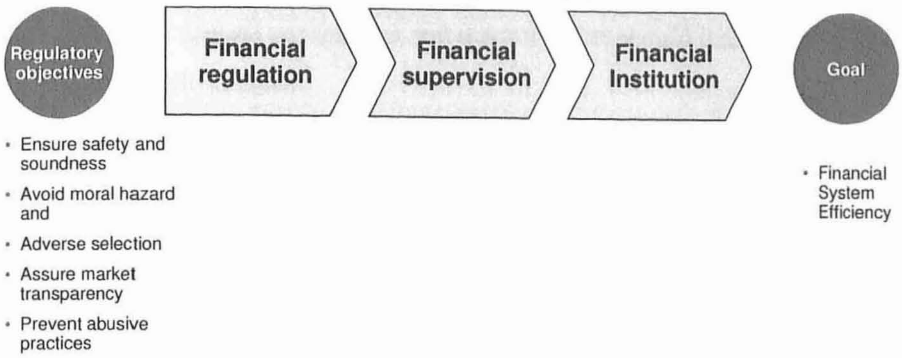
However, in the same turn as financial regulation and supervision protects an economy, it also impacts the efficiency of a domestic financial system, which is why Smith and Walter (2003) consider the loss in efficiency as something of an "insurance premium" which offsets sometimes results in gains in the safety and stability of the system. Therefore, by both imposing benefits and costs on participants, countries should strive for optimum rather than minimum regulation that will attract transaction flows to particular markets.[19]

Unfortunately, there is often no easy differentiation between the regulatory and supervisory tasks of the controlling bodies.[20] Figure 3 gives an illustration of the general conflicting objectives between efficient financial markets on the one side, and regulatory objectives on the other side. Hence, to ensure a sound- and properly functioning financial market, financial regulators set the level playing field for the actors in the financial markets by means of directives, laws, and codes of conduct, while financial supervision is seen as the executive force controlling for compliance with the regulatory restrictions.

[19] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

[20] www.wwz.unibas.ch/cofi/efma/papers/103.pdf

Figure 3: Overview of the regulatory and supervisory system for financial institutions



Source: Adapted from Smith and Walter (2003)

Traditionally, most EU countries relied (at least in part) on their respective central bank, or an independent supervisory agency working in cooperation with the central banks, for all aspects of regulation and supervision of the financial markets and its participants (usually except for insurance and in some cases specialized activities like mortgage banking placed under separate regulatory authorities).

In the next chapter I will attempt to review the major regulatory and supervisory policies taken by the EU to integrate Europe's financial market and attempt to evaluate if and how they caused the desired output – namely integration.

6.3 Regulatory and Supervisory System across the EU

The First Banking Directive of 1977 is widely acknowledge being the first concrete step towards a single European financial market. Although this directive does not directly encourage pan-European financial service provision per se, it seeks to ease market entry for European Community (EC) banks into other EC member state[21] by laying down certain basic common standards, attempting to prevent discriminatory barriers to market entry.[22] Initially, the First Banking Directive relied on host country regulation, which however was ratified in 1979 via the twin pillars of mutual recognition of their respective regulatory systems and home Member State control of pan-EC market activity, ensuring that all Member States were subject to minimum standards in the interests of investor protection, systemic stability, and effective mutual-recognition. Rather than establishing uniform regulation and supervision for a single financial market, the principles of

[21] At that time Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom

[22] These conditions include the requirement for new potential entrants to maintain capital separate from the resources of the main company, to meet a certain initial capital requirement test, and, finally, to be directed by at least two persons of "sufficient repute" and of "sufficient experience".

home country control, harmonization of essential principles, and mutual recognition were applied, assuming that mutual recognition and market forces would interact to yield convergence in the regulatory environment.[23]

These developments led to the Single Market Act (SMA), which was originally announced in 1983, agreed on in 1987, and implemented at the end of 1992. The SMA of was a part of the EC's White Paper[24], which was an "action to achieve a single market by 1992" by means of allowing the free movement of goods, capital, people, and ideas. The goal was to enhance economic growth in the EC (from now on referred to as the EU) by moving toward free markets and more open competition.[25] Amongst others, with this White Paper the EU adopted an approach for banking, insurance, and securities providing a regulatory passport under which issuers, collective investment schemes, and investment firms could operate across the EU free of obstructive- and costly host Member State rules.[26]

This initiative was furthermore complemented and strengthened by the Second Banking Directive of 1989. The Second Banking Directive (SBD) henceforth permitted companies to secure a license in their home countries and use this as a 'passport' to offer its services anywhere in the EU.[27] The SMA came together with the SBD into force in 1993 and provided the framework for an integrated banking sector.

Due to the national differences inherent in the different Member countries prior to these developments, potential conflicts were though arising which needed additional amendments.[28] Hence, to ensure and restore fairness, harmonization of capital requirements were the solution to create a level playing field, the Own Funds Directive and the Solvency Ration Directive sought to establish common ground rules, i.e. the Capital Adequacy Directive (CAD) that was to regulate functions instead of institutions. The CAD established uniform capital requirements applicable to both universal banks' securities operations and non-bank securities firms.

Parallel, the Basel Committee established in 1988 an agreement regarding common capital

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[23] Gjersem, C. "Financial market integration in the euro-area", *OECD Working Paper,* No. 368, October 2003

[24] from 1985, to be found at http://europa.eu.int/comm/off/pdf/1985_0310_f_en.pdf

[25] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

[26] Molony, N. "The Lamfulussy Legislative model: a new era for the EC securities and investment services regime", *International and Comparative Law Quarterly*, 52(2), 2003

[27] At the same time, the directive established certain minimum standards that home country authorities need to apply in granting such licenses, including a minimum authorized capital of 5 million ECUs, the provision of information on major shareholders, and limitations on a bank's holdings in non-financial institutions.

[28] The Continental or German model of universal banking would be competing with the Anglo-Saxon, or British model that generally separates banking and securities activities. As a result would for example the securities operations of Germany's universal banks be competing with Britain's non-bank securities firms, which caused distortion in respect to the fairness of competition.

adequacy requirements which also came into force in 1993. Because the EU's CAD was developed at the same time as the Basel Committees Capital Accord[29], the two initiatives influenced each other and one might say that what Europe was pursuing locally was what Basel was pursuing globally.[30]

Perhaps the biggest step towards integrating Europe's financial market came with the Maastricht treaty and the subsequent agreement to create a European Monetary Union (EMU) that included the use of a common currency, the euro. Mr. Duisenberg, former president of the European Central Bank that was established as a consequence of the EMU, said that "the introduction of the euro has had – and will continue to have – a powerful influence on European financial market developments and integration".

In light of the EMU just a minor thing, the Investment Services Directive (ISD), which came into force in 1996, heralded the completion for pan-European operation of the three major financial services (banking, insurance, and investment services), by creating a 'European Passport' for non-bank investment firms to carry out a wide range of investment businesses as well as certain additional services (such as investment advice, advice on mergers and acquisitions), in all Member States.[31] Unlike the single license in banking, however, this 'European Passport' did not go as far was the SBD, thus, the establishment of e.g. insurance branches in other countries still requires the authorization of the host country.

One would expect that all possible and necessary steps were ratified and that Europe's financial services industry would rapidly integrate. However, by 1998 it became clear that the progress was disappointing. For example was the legal structure, which constructed and regulated the EU securities and investment services market, failing as large areas of regulation remained largely unharmonised (e.g., control of market manipulation, conduct of business regulation, and securities trading market regulation) notes Molony (2003). Additionally, Molony finds that that the regime was ill-equipped to cope effectively with the enormous demands that were placed on it such as the

[29] The capital held by any firm helps to absorb possible business losses and thus protect its creditors. Consequently, bank supervisory agencies have an interest in maintaining adequate capital in the banking system and have used their authority to impose minimum capital requirements. The Basel Committee on Banking Supervision adopted the Basel Capital Accord, which explicitly linked capital regulations to a bank's degree of risk. By establishing minimum capital requirements that were internationally comparable, the Basel Accord paved the way for more uniform capital requirements across countries, by requiring banks to hold as capital at least 8% of their risk-weighted assets. Four risk weights or "risk buckets" were created. The first bucket, generally consisting of claims on OECD governments (which includes the U.S.), has a zero weight. The second bucket, generally consisting of claims on banks incorporated in OECD countries, has a 20% weight. The third bucket, consisting of residential mortgage claims, has a 50% weight, and the fourth bucket, generally consisting of claims on consumers and corporations, has a 100% weight. Following the adoption and phasing in of the Accord, the amount of capital held by banks increased substantially.

[30] Bikker, J.A. "Competition and efficiency in a unified European Banking market", *Edward Elgar*, 2004

[31] http://europa.eu.int/comm/internal_market/en/smn/smn2/s2mn13.htm

arrival of the EMU, the Internet 'explosion', technological developments in the securities trading environment, and market restructuring (such as the growth of financial conglomerates and the arrival of competition and consolidation in the securities trading market field). The prime reasons for this disappointing result were amongst others the inconsistent and delayed implementation of directives and underdeveloped supervisory co-operation, on which the effectiveness of home Member State supervision and the systemic stability of the integrated market were dependent. With the introduction of the common currency and a response to the lacking progress, the European Commission decided in 1999 to set out a program that investigated what caused the delay and what needed to be done in order to kick-start financial integration. The result of this initiative was the Financial Services Action Plan (FSAP), which outlined forty-two measures (an overview of these measures is illustrated in Appendix A).

Anxiety about the slow progress of the FSAP resulted in 2000 in the establishment of a Committee of Wise Men on the Regulation of European Securities Markets under the chairmanship of Alexandre Lamfalussy (Blokland and Zech, 2002). It was asked to assess the current conditions for the implementation of the regulation of securities markets in the EU, how the mechanism for regulating those markets can best respond to developments, and, in order to eliminate barriers, to propose scenarios for adapting current practices to ensure greater convergence and cooperation in day-to-day implementation. [32]

The Committee concluded that the EU's current regulatory framework is too slow, too rigid, complex, and ill-adapted to the pace of global financial market change. Lamfalussy made the following remarks to the Press[33]: "The European Union has a great opportunity to strengthen its economy, improve its long-run competitiveness and investor returns for all citizens, if it can create a single financial market in the next few years. But this can only happen if the European regulatory system is made more efficient and decisions are taken in a timely way, at the right level. We can no longer afford the luxury of regulatory inefficiency in the instantaneous Internet age. Financial markets are changing by the week – and European regulation is simply not up to speed."

For its report, the Committee of Wise Men conducted an online survey[34] asking about the current hurdles for greater financial integration across Europe; the results are illustrated in Figure 4.

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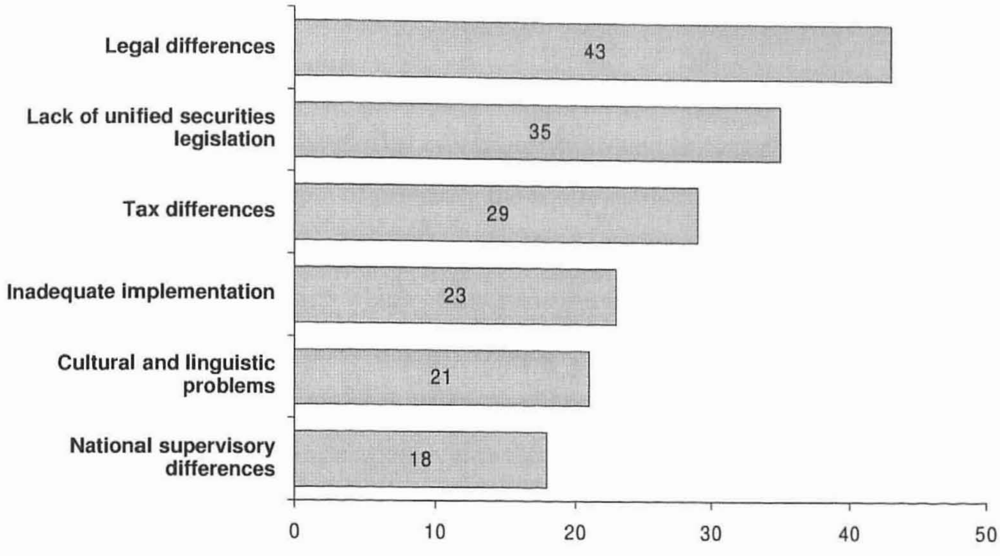
[32] Committee of Wise Men, "Final report of the Committee of Wise Men an the regulation of European securities markets", February 2001

[33] Summary of remarks made by Alexandre Lamfalussy, Chairman of the Committee of Wise Men on the Regulation of European Securities Markets, to the Press concerning the Committee's initial report published on November 9, 2000

[34] For this ad hoc questionnaire in total 69 responses were received from a wide range of market participants all over the European Union and from third countries (the US and Switzerland).

Figure 4: Main obstacles standing in the way of an integrated European securities market (in absolute numbers)



Source: Committee of Wise Men, "Final report of the Committee of Wise Men an the regulation of European securities markets", February 2001

Despite not being representative it appears nevertheless, that except for cultural and linguistic problems, all of the stated obstacles date more or less back to insufficient regulatory and supervisory harmonization. Legal differences are the most prominent obstacles felt by 43 out 69 respondents, followed by a lack of unified securities legislation and tax differences. Particularly in respect to the legal problems is Europe's takeover directive a case in point.[35] As Smith and Walter (2003) note, regulations for takeovers are numerous[36] and until a few years ago, they were vastly different from one another, creating a confusing and often uneven playing field for participants. In recent years, efforts have been made to harmonize these regulations, but progress has been modest, although an end was near in mid-2001 after 12 years of work.[37] However, the German government had second thoughts, which caused further delays and modifications. Eventually on May 20, 2004

[35] The Takeover Directive aims to provide a framework of common principles for cross-border takeover bids, create a level playing field for shareholders and establish disclosure obligations throughout the Union.

[36] These include regulations, securities laws, or regulations relating to fraudulent practice such as required disclosures, trading restrictions (such as insider trading), and prohibitions against making false markets. There are also rules, codes, and established procedures prescribed by stock exchanges or self-regulatory bodies that may or may not be supported by enforcement powers. These various tiers of regulation can be imposed at national and at the EU levels.

[37] The directive required bidders who acquired control of a company to make an offer to all shareholders on the same terms, and prohibits frustrating defensive tactics unless these have been approved by shareholders – in effect barring poison bills that do not have shareholder approval. The German government resisted this provision, reflecting a basic antagonism to a free and transparent market for corporate control. Yet in absence of this provision, the entire EU takeover code is relatively meaningless.

the directive was ratified – after 14 years of negotiations.[38] The final outcome caused a great deal of criticism because it was characterized by 'too much' consensus, thereby making it in many eyes weak and ineffective.

The Lamfalussy Committee therefore calls for a four-level approach to decision-making and implementation of financial-market proposals (illustrated in Appendix B), which will help to kick-start the integration progress of primarily the equity markets. At the first level, the Council of Ministers, the European Commission and the European Parliament would agree on 'framework' legislation and would decide which of the measures to be implemented should be passed to the next level. At this second level, a newly created 'securities committee', made up of representatives of the commission and of member states, would reach agreement within three months on the technicalities of the new legislation, which they would do after consulting market participants and consumers. Levels three and four of the Lamfalussy approach to decision-making involve co-operation among national regulators via a 'regulators committee'. Its purpose will be to improve the implementation of EU legislation by the better enforcement of EU rules.[39] While having a large pool of supporters, Lamfalussy's recommendation of centralizing capital market regulation in one pan-European entity, similar to the SEC of the US, also had opponents, e.g. Kern (2002) who argues that "until EU financial markets become more integrated, a single EU securities regulator would not be an efficient or effective institutional model for EU securities markets." The complexity of this discussion is therefore similar to the 'chicken and the egg' problem. Are major changes necessary to advance further in the integration process, or should the EU wait for wider integration before initiating new measures to avoid an 'integration-overload'?

The same changes that seemed to slow down the integration process in the EU in the end of the 1990s, took its toll on the Basel Capital Accord, or Basel 1. Hence, Basel 2 was proposed in 1998. As Trichet, President of the ECB, noted in a recent speech: "the average bank of 1988 [...] is a very different animal compared with the average bank today".[40]

The controversy over the new risk classifications, and the cost to banks of administering the new approach led to delays, and Basel 2 was first agreed upon on June 25, 2004 and is intended to

[38] for a more elaborate review of Europe's takeover directive see for example Bergloef, E. Burkart, M. "European takeover regulation", *Center for Economic Policy Research*, 2003

[39] "A ragbag of reform", *The Economist*, March 3, 2001

[40] Trichet, J. C. "Integration of the European financial sector", Introductory remarks at the International Banking Event, Frankfurt am Main, June 29, 2004

come into force in stages from the end of 2006.[41] Unlike its predecessor, Basel 2 will be based on three pillars[42], the most noteworthy being the introduction of more comprehensive and risk-sensitive rules, forcing financial intermediaries to set aside capital not only to take credit risk into consideration, but also for their operational risk. Although being acknowledged as being a great improvement to the old Basel accord, Benink and Wihlborg (2001) note that the three pillars of Basel 2 are not 'strong' enough to avoid banks from 'gaming and manipulating' with the risk-weights when using the internal ratings option, which is why they suggest that issuing of subordinated debt would better help the market discipline pillar, and thereby the overall Basel 2 accord.

From a regulatory perspective, the above mentioned developments seem to be the most formative, and although not all of them originate and affect solely the EU, i.e. the Basel accord, the importance of these developments are undisputable.

I will now turn to the supervisory side to investigate whether the above-mentioned regulatory attempts were supported by an appropriate supervisory infrastructure. As mentioned already and illustrated in Figure 3, financial supervision controls the compliance of financial market participants with the regulatory framework. In order to do so, the means for supervision range from self-control, over public supervision and enforcement, through the criminal and civil justice system. In addition, stakeholders in general and shareholders in particular are increasingly filling supervisory functions, by monitoring and reporting any misconduct.

In Europe financial services supervision is nationally organized and enforced through the pan-European principles of minimum harmonization, home country control, and mutual recognition, while any further co-operation between those institutions is based on a network of bilateral memoranda of understanding (MoUs).[43] Supervision on a national basis permits the authorities to operate near the entities subject to control, and it favors a constant exchange of information and direct contact with intermediaries.[44]

One would suppose this being advantageous, as it is fast and efficient, though on the other hand

[41] "Basel 2", *The Economist*, July 1st, 2004

[42] The first pillar deals with the minimum regulatory capital requirement and contains new rules for calculating more refined risk weights for different kinds of loans. Moreover, it suggests that capital should be held against so-called operational risk. The second pillar is the supervisory review process, which requires supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital based on a thorough evaluation of its risks. The third pillar aims to bolster market discipline through enhanced disclosure by banks. Although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for application to banks of varying levels of complexity and sophistication.

[43] http://www.epfsf.org/meetings/2002/briefings/briefing_8oct2002_more.htm

[44] Fazio, A. "Regulation and supervision in financial markets" Presentation the European Banking Congress 2004, Frankfurt, November 19, 2004

this system is also very 'flexible' in terms of interpreting and enforcing regulations, which is of concern in some Member states when it crosses the interests of 'national champions' that are threatened by competition from abroad. Moreover, in terms of efficiency for example, the multiple reporting requirements to various national supervisory institutions implies a cost burden to institutions operating in more than one member state, which similarly causes a competitive distortion as large institutions can carry the additional cost burden more easily than small ones. In addition, the fact that different supervisors enjoy different levels of competence and attach different relative weights to the objectives, results often in inconsistent implementation of EU legislation and is therefore a major obstacle to a single market. Also the IMF and the BIS have raised concerns presuming that the current arrangement of national supervision may not be conducive to guaranteeing an effective supervision of institutions operating in several Member States.

The fact that financial institutions of all types are increasingly offering products and services (directly or through affiliates) that compete not only against those offered by similar types of institutions but also against those offered by other categories of service providers, complicates the task of supervision even further.

Trichet (2004) therefore concludes that regulatory convergence has to be complemented by supervisory convergence. To achieve this goal, several proposals are currently under discussion; should there be one single European financial services supervisor or merely an intensification of bilateral and multilateral co-ordination by stepping up their information exchange and identify best working practices?

It is widely believed that the most efficient institutional structure is to place financial services supervision at an independent, but politically accountable agency, which, at the same time is mandated to maintain a close exchange of information with the central bank. The ECB and many national central banks have therefore called for banking supervision in Europe to be entrusted to central banks, while the leading role for co-ordination on a European level would be given to the existing Banking Supervision Committee of the ECB.

6.4 Degree of Europe's Financial Market Integration

Reaching a single and unambiguous verdict of the degree of integration in the financial sector is very difficult because the financial services sector is a multi-product industry with a differing degree of integration of ducts and markets, notes Padoa-Schioppa.[45] Nevertheless, there is consensus that the past measures have been considerable, in particular the EMU. Several studies have been made, notably Adam et al. (2002), Adjaouté and Danthine (2003) and Baele et al (2004), which attempt to measure the degree of integration. Though first of all its seems important to define financial market integration. Baele et al (2004) define it as follows:

The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics (1) face a single set of rules when they decide to deal with those financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market.

In other words, full integration requires the same access to banks or trading, clearing and settlement platforms for both investors and firms, regardless of their region of origin. In addition, once access has been granted, full integration requires that there is no discrimination among comparable market participants based solely on their location of origin.

The next question that arises is how can financial integration be assessed or measured? From a theoretical point of view, a perfectly integrated market is where the 'Law of One Price' holds, which states that if assets have identical risks and returns, then they should be priced identically regardless of where they are transacted.[46]

However, basing an assessment on one parameter only, is potentially dangerous due to the possible bias and one-sided assessment, hence, I will complement this analysis where feasible by means of other quantitative indicators, such as foreign presence in domestic markets and access of residents to other Member States markets. Though it is important to keep in mind that the mere presence of cross-border activity in a market place does not deliver absolute proof of financial market integration, it is though an indication that markets are contestable to some degree.[47]

In order to assess financial market integration systematically out of a wide body of literature on this issue, I will in the following focus on some key segments of the financial market. Also Schüler

[45] Speech by Padoa-Schioppa, T. (member of the executive board of the ECB) "The evolving European financial landscape: integration and regulation", a Colloquium organized by Groupe Caisse des Depots/KfW, Berlin, March 22, 2004

[46] In addition to financial instruments, the law of one price should also apply to the goods market. However, given transportation costs and other frictions (non-fungibility, non-storability, etc.) that are impossible or difficult to remove, the law of one price is unlikely to hold as well in the goods market as in financial markets.

[47] The reader should be aware that also other means exist to analyze financial integration, such as the 'news-based measures', used by Baele et al (2004). Assuming that in a financially integrated area portfolios should be well diversified one would expect news (i.e. arrival of new economic information) of a regional character to have little impact on prices, whereas common or global news should be relatively more important. This presupposes that the degree of systematic risk is identical across assets in different countries. If that is not the case local news may continue to influence asset prices, indicating that integration is not complete.

and Heinemann (2002) argue in the context of measuring integration, the distinction between wholesale capital markets and retail financial markets becomes crucial. In the following, I will though adopt a more narrow view, focusing on four financial market segments, namely the money, the government bond, the equity, and the credit or retail market.[48]

6.4.1 Money Market

The money market is commonly defined as the market for short-term debt, where 'short-term' means a maturity of up to one year. Plotting the cross-sectional standard deviation of one- and 12-month, as well as overnight interest rates of the previous 10 years from the 12 euro-area countries, as shown in Appendix C and Appendix D, illustrates that the convergence process started around 1996 or early 1997[49], and collapsed following the introduction of the euro in 1999 to a very low level.[50] This does, however, not point to a sudden integration but is merely a consequence to the absence of exchange rate risks and the gradual harmonization of national economic policies, as Baele et al. (2004) note.

Nevertheless, the measures taken to create an integrated market sphere in the money market have shown its results with the uniform conditions across the EU and the high degree of integration that prevailed very shortly after the EMU in 1999. This is supported by the study Santillan et al. (2000) conducted who investigated the effects of the introduction of the euro in 1999 on euro-area bond and money markets. Based on measured interest rate differences across countries and market survey data, they concluded that the unsecured money market segment very quickly became highly integrated. Galati and Tsatsaronis (2001) support this partially, noting that the impact of the EMU has been considerable, but the progress towards integration has been uneven across different market segments. Also Baele et al. (2004) show that not all segments of the market have yet reached the same level of what might be called 'near-perfect' integration. It is therefore necessary to distinguish between the unsecured and the secured parts of the money market, where the euro-denominated interbank unsecured money market is an integrated market, while the secured money markets are less integrated.[51]

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[48] These markets could also be classified more narrowly, e.g. in terms of transaction size, instruments, and client groups, though I do not deem this necessary here.

[49] If the market is fully integrated the ratio will be close to one.

[50] The remaining dispersion in euro area bank lending rates, as illustrated by the 'box-in-the-box' diagrams, is chiefly linked to the local character of some lending activity and broadly similar to the degree of dispersion than can be registered within some of the larger Member states. Rates for consumer loans within Germany for example, vary between 5.5 and 13.7 percent for loans up to € 100,000 (Deutsche Bundesbank, Monthly Report, July 2003)

[51] "Financial Integration Monitor 2004", *European Commission DG Internal Market*, April 28, 2004

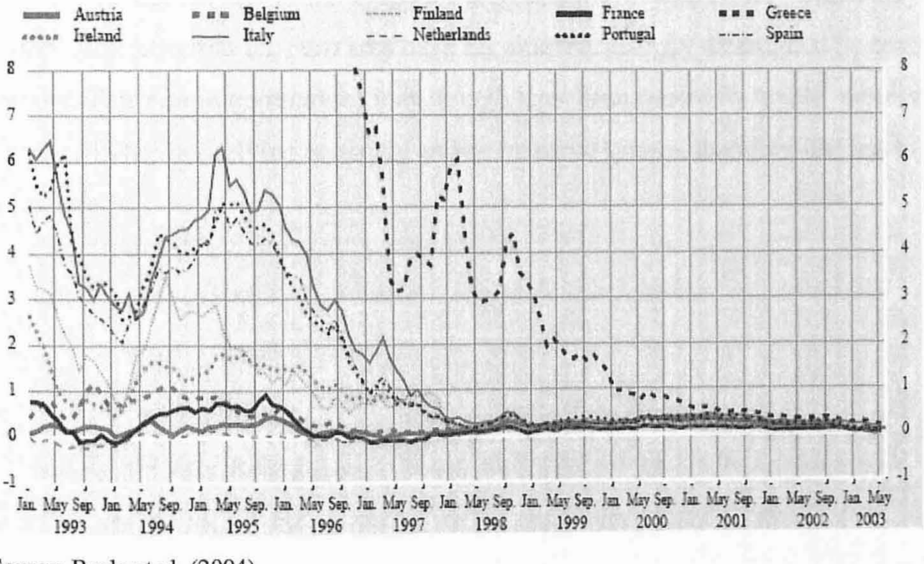
6.4.2 Government Bond Market

Similar to the money market, the common currency had great impacts on conversion in the government bond market. The potential benefits from an integrated government bond market are considerable, because governments can reduce the cost of servicing their debt considerably because it is easier for investors to diversify geographically and thereby largely eliminate their exposure to purely local economic shocks. This, in turn, should reduce the yield required by investors and result in lower interest payments for governments.

Adjaouté and Danthine (2003) found in a recent study that considerable convergence has taken place, though, according to their estimations, a further integration could potentially reduce debt servicing costs for the euro-area by €5bn per year. This is in line with the findings from Hartmann et al. (2003) who find, that the bond market has converged rapidly after the EMU, although to a lesser extent than the money market.

As eminent from Figure 5, plotting the spread between yields in the various euro-area government bond markets relative to Germany's bond yields between 1993 and 2003 (10-year maturity segment), the yield spreads have become very small as of early 1998, with the exception of Greece.

Figure 5: Yield spread for 10-year government bonds relative to Germany



Source: Baele et al. (2004)

Although full integration in the government bond market has not yet achieved, Baele et al. (2004) found that investors were eager to benefit from the improved diversification benefits of an almost integrated EU government bond market. As a consequence, investors have considerably increased their holdings of non-domestic bonds, which is a very positive sign towards full integration, reducing home bias of bond markets.

6.4.3 Equity Market

In the equity market, a good sign towards integration is the increased cross-border equity trading that led some of Europe's stock exchanges to expand, or to consider expansion, across their national borders. So far, consolidation among exchanges has though been limited to the merger of the Amsterdam, Brussels, and Paris exchanges in September 2000, which now constitutes Euronext. However, Deutsche Börses' renewed battle, though now in competition with Euronext, to take over the London Stock Exchange, as well as considerations in the Nordic countries to merge their trading platforms, illustrates that there is a strong urge for streamlining and merging particularly the various small European equity markets.

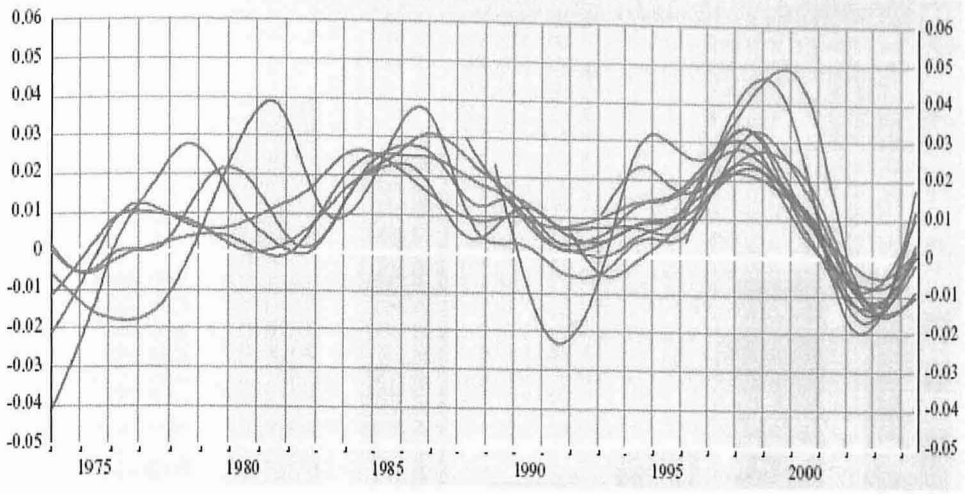
With a further integration of equity markets in Europe, several potential benefits can be achieved such as decreasing costs of equity capital and access to a much larger pool of funds for corporations, widening the supply of financing to the entire euro-area. Nevertheless, massive concerns are voiced by entities losing out in the consolidation game raising concerns about monopoly pricing if e.g. Deutsche Börse's take-over attempt of the London Stock Exchange succeeds.[52]

Figure 6 plots a Hodrick-Prescott (HP) filtered return series[53] for the 12 EMU countries from 1973 through 2003, which shows that the HP-filtered returns vary widely during the 1970s and 1980s. However, from the end of the 1990s these returns move more closely which may suggest that equity returns across the euro area have become increasingly determined by common euro-area factors. This rise in correlations may though have been caused by 'cycle' rather than structural changes in the underlying economy and/or financial system, therefore one has to read this figure with care.

[52] Cohen, N. "Fresh hurdles for Börse LSE bid", *Financial Times*, January 11, 2005

[53] The Hodrick-Prescott filter is a smoothing method that is widely used among macroeconomists to obtain a smooth estimate of the long-term trend component of a series.

Figure 6: EMU countries' HP-filtered equity returns

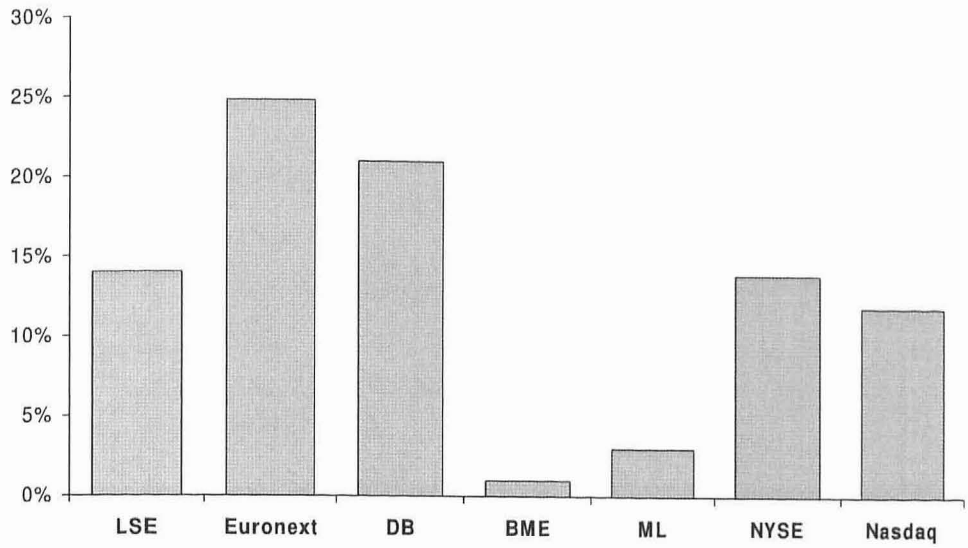


Source: Baele et al. (2004)

Another, quantitative approach to evaluate the integration of Europe's equity markets is to look at the degree of foreign listed companies in a countries stock exchange. What appears from Figure 7 is that the major European equity platforms, such as the London Stock Exchange, Euronext, and Deutsche Börse, have a relatively large proportion of foreign listed companies compared to the New York Stock Exchange and Nasdaq from the US. For the smaller European exchanges, notably Spain's and Italy's this does not surprisingly look different, with only marginal foreign listings. With between 15-25 percent of foreign companies listed on Europe's largest stock exchanges, taking parallel into consideration that also companies from non-EU states use this option, this number appears then relatively small.

An inhibiting factor for more extensive foreign listing of especially European companies, are the various national stock exchanges. And although it is generally acknowledged that there are large benefits from diversifying equity portfolios across countries and/or sectors, in reality particularly private investors still seem to allocate a disproportionately large fraction of their equity holdings to domestic listed firms. This is likely caused by the well-documented higher costs of cross-border trades compared to the costs of domestic trades, accompanied by the home country advantage in terms of information search costs.

Figure 7: Proportion of foreign listed companies (in Dec. 2003)

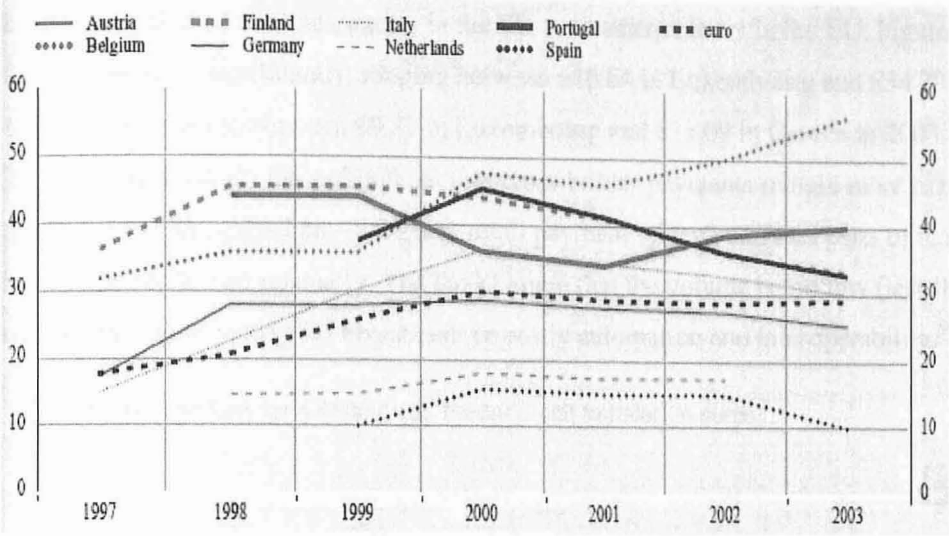


Source: "Financial Integration Monitor 2004", European Commission Internal market DG, Working Paper, April 28, 2004

Guiso et al. (2003) find in their study, after analyzing the current state of equity ownership in several European countries, that while households' equity market participation has increased, there remain considerable country-specific differences. They conclude from this that euro-area investor's face different levels of participation costs, which suggests that there are still a number of barriers that need to be overcome before full integration is reached.

Nevertheless, the study by Adam et al. (2002) shows that institutional investors now increasingly complement their portfolio with non-domestic shares, though the majority of these non-domestic shares are non-European. Nevertheless, Baele et al. (2004) illustrate in Figure 8 that the share of Europe-wide investment funds is increasing, amounting to 18 percent in 1997and increased to 29 percent by 2003.

Figure 8: Asset share of euro-area investment funds with European investment strategy



Source: Baele et al. (2004)

In this respect it is though interesting to note that both Baele et al. (2004) and Ehling and Ramos (2002) found that the advantages of sector diversification have in 2000 for the first time in the last 30 years surpassed those of geographical diversification. This means that greater benefits can be derived from investing in different sectors rather than different countries. In addition, equity returns in general have become increasingly sensitive to European shocks, rather than pure local shocks, which indicates a considerable degree of integration in the Europe's equity markets, while in the same time being an incentive to invest more in non-European equity.[54]

Nevertheless, the degree of integration in Europe's equity markets is relatively weak. Emiris (2002) concludes for example in his study that European equity markets are not perfectly integrated. Hartmann et al. (2003) also found only weak evidence that some integration in equity markets took place over the past few years.

6.4.4 Retail market

Assessing the degree of integration in the retail banking area is probably the most complicated task, due to two major reasons, the limited availability of data, and the intrinsic characteristics of retail banking. Despite the difficulties of applying the Law of One Price, one would though expect to see similar impacts of the EMU in the retail market with price differentials across countries to diminish gradually.

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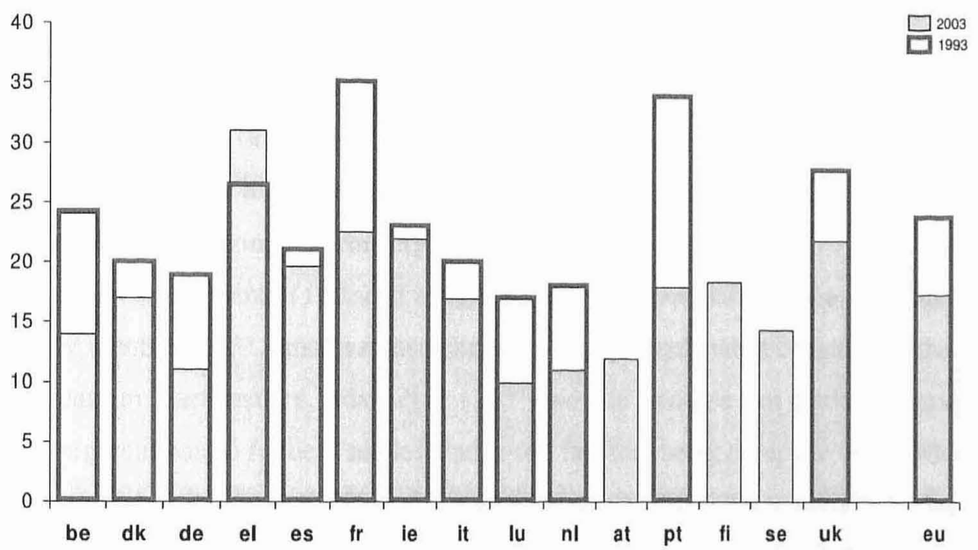
[54] "Financial Integration Monitor 2004", *European Commission DG Internal Market*, April 28, 2004

A rather simple way to measure integration in the retail market is to compare the cost of transferring €100 from one country in the EU to another country in the EU. Figure 9 illustrates that these costs vary significantly, ranging between €16.84 in Luxembourg and €34.79 in France in 1993, to decrease to between €9.89 in Luxembourg and €31.09 in Greece in 2003.[55]
The banking industry has pointed out that cross-border payments remain more expensive due to the lack of an integrated pan-European retail payment system, and that parts of these payments have to be processed manually. The banks argue that the volume is too low (less than 1 percent of total transfers) to justify the investment in costly automation and interoperability.[56]

Figure 9: Average fees for a €100 cross-border credit transfer (in euros)



Source: "Financial Integration Monitor 2004", European Commission Internal Market DG, 2004

Similarly to the costs of cross-border transfers, the time it took before a cross-border transfers was executed, looks also 'very disintegrated' and far from domestic conditions, despite improvements in reducing the average time-span to just under 3 days in 2003, compared to 4.5 days in 1993.
So although EU regulation in this area did not result in prices to converge between countries, the creation of the pan-European clearing system in November 2003 (STEP2)[57] can be expected to foster significant improvement in convergence.[58]

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[55] Ibidem.
[56] Gjersem, C. "Financial market integration in the euro-area", *OECD Working Paper,* No. 368, October 2003
[57] STEP2, offers a clearing system for settling euro payments between countries in the EU. This covers credit transfers of up to €12,500
[58] "Financial Integration Monitor 2004 - Background Document", *European Commission DG Internal Market*, 2004

Furthermore, Appendix E illustrates the interest rates for both short-term and medium- to long-term loans to companies. It appears from the graph that overall recent years saw a pattern of decreasing dispersion for both short-term and medium- to long-term interest rates to companies, although the short-term dispersion of interest rates has slowly increased since 2000. Similarly, Appendix F illustrates the interest dispersion of interest rates for mortgage loans and consumer loans since 1990. Also here a general pattern of decreasing dispersion is evident, however, the dispersion of mortgage loans is relatively low compared to consumer loans. Nevertheless, as particularly consumer loans also experience widespread differences within countries, and are dependent on personal characteristics, it is not very surprising that the same pattern appears on a pan-European scale. Consequently, integration in the retail markets may be considered quite advanced from a legal perspective, but price differentials remain relatively high and non-regulatory barriers to integration continue to exist and are, for instance, due to cultural differences in consumer behaviors or preferences for different types of credit. To that comes that the retail market is still a very localized phenomenon with different underlying characteristics of credits, which might make complete convergence almost impossible.

In its broad assessment of financial integration, the EU Commission[59] also concludes that lending activity within the EU remains rather fragmented, particularly when considering the retail end of the spectrum. Furthermore, Adam et al. (2002) provide evidence that market integration in the retail segment has so far been modest and is still far from being complete while, which is supported by Cabral et al. (2002), who note that market segmentation remains strongest in the retail area. The results of Kleimeier and Sander's (2002) study indicate though that the EMU had, and will most probably continue having, an important impact on the emergence of a single retail banking market in Europe. Padoa-Schioppa (2000) on the other hand appears though less optimistic and expects that indications for widespread cross-border operations in retail banking should not be expected very soon. And while Schüler and Heinemann (2002) conclude that retail financial markets still reveal substantial fragmentation they acknowledge that national retail financial markets will remain segmented to a certain degree.

[59] "Financial Integration Monitor 2004", *European Commission DG Internal Market*, 2004

6.5 Conclusion

Significant measures have been undertaken to create a level playing field that would encourage the integration of Europe's financial markets. Hence, the integration appears advanced from a legal perspective, and Buch and Heinrich (2002) note in their study that the existence of the various directives affecting banking has led some commentators to suggest that Europe might be considered as one of the most integrated banking markets worldwide.

The systematic analysis of four key segments of Europe's financial market has however revealed that there appear to be differences in the progress of integration, illustrated in Table 1.

Table 1: Degree of integration of the four key financial market segments

Degree of intergration		Financial Market Segment	
	High	**Money**	Unsecured
			Secured
		Goverment Bond	
		Equity	
		Credit/retail	Medium-long-term loans to enterprises
			Short-term loans to enterprises
			Mortgage loans
	Low		Consumer loans

Source: Own illustration

While the money market appeared to be the most integrated, the credit or retail market showed least signs of integration. There are though also differences within these broad segments, hence the unsecured money market appeared more integrated than the secured money market. Similarly, the interest rate dispersion for the medium- to long-term interest rates of loans to enterprises showed more conversion than the interest rate dispersion for consumer loans, which was the most fragmented market segment.

Nevertheless, the enforcement of the various regulations and directives materialized very slowly mainly caused by the less unified supervisory structure as well as diverging national interests. In addition Gjersem (2003) notes that the remaining obstacles to deep integration are rooted in different legal, administrative, accounting, tax and consumer protection systems, which will need to be dismantled to achieve to objective of an integrated European financial market.

This is supported by several European bankers who claim that national politics were still hindering banking consolidation. Asked what was the biggest obstacle to banking mergers in Europe, Rijkman Groenik, ABN Amro CEO, said: "Politics". He added: "A number of central bankers said that in itself supervisory rules are not an obstacle, but of course supervision can be used for politics"[60], giving a broad hint to the French and German central bankers. They insisted though that prudential rules were not being used to protect national banks from takeover. Instead the lack of cross-border activity was largely down to different tax rules, consumer protection standards, and national characteristics.[61]

7 Part 2 – Consolidation Activity in Europe

In at lecture at the London School of Economics, Howard Davies, the former Chairman of UK's Financial Services Agency (FSA)[62], noted that the ultimate test for an integrated market is whether it is responding in terms of cross-border consolidation activity and whether it is producing the supposed benefits of a deeper and more liquid financial market.
In this chapter of the thesis I will therefore review and analyze the consolidation activity in Europe of the past decade, before turning more specifically to the consolidation developments of the financial services industry and here specifically banking.

7.1 Consolidation Activity

It is undisputed that particularly towards the end of the 1990s an unprecedented wave of M&As affected not only the European markets but most industrialized countries. The reason for the increase in European M&A activity has been the growing recognition of the need for industrial restructuring following the adoption of the single European market and the EMU by EU countries, note Smith and Walter (2003). Yet also other factors such as the low-growth high-unemployment environment which created great pressures to improve the competitive performance and efficiency, as well as the collapse of the communist powers in Eastern Europe contributed to the restructuring. Furthermore, innovation and changes in technology, notably IT, indirectly triggered consolidation being the most dynamic source of change in the whole economy (Cameron, 1997). Steger et al. (2004) therefore claim that technology also has a great impact on M&A activity with its role being

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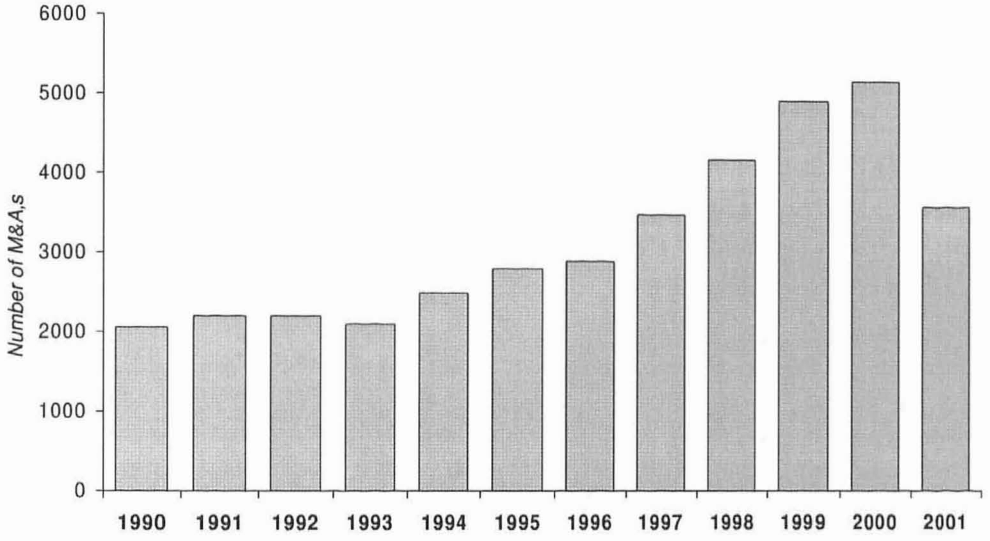
[60] Parker, G. "Bank merger rules to be reviewed by Brussels", *Financial Times*, September 12, 2004
[61] Ibidem.
[62] Davies, H. "Creating a single financial market in Europe, what do we mean?", available at: http://www.lse.ac.uk/collections/LSEPublicLecturesAndEvents/pdf/creatingAsingleFinancialMarketInEurope.pdf

threefold: as the initiator, the enabler, and the aim of M&A.[63]

Different from the previous consolidation wave in the 1980s, where the manufacturing sector accounted for the majority of deals, the most recent M&A wave[64] of the 1990s experienced a relative unimportance of manufacturing - accounting for only 35.1 percent of the total value of such transactions (Evennett, 2002). The service sector on the other hand was the most active, particularly financial intermediation, telecommunications, electricity, media, and transportation. The overall number of M&A's in Europe, as illustrated in Figure 10, grew from 2,257 announced deals in 1990 to 2,832 in 1995 and reached its peak of 5,577 in the year 2000.

Figure 10: Number of M&A's announced in the EU 1990-2001



Source: Metwalli and Tang (2003)

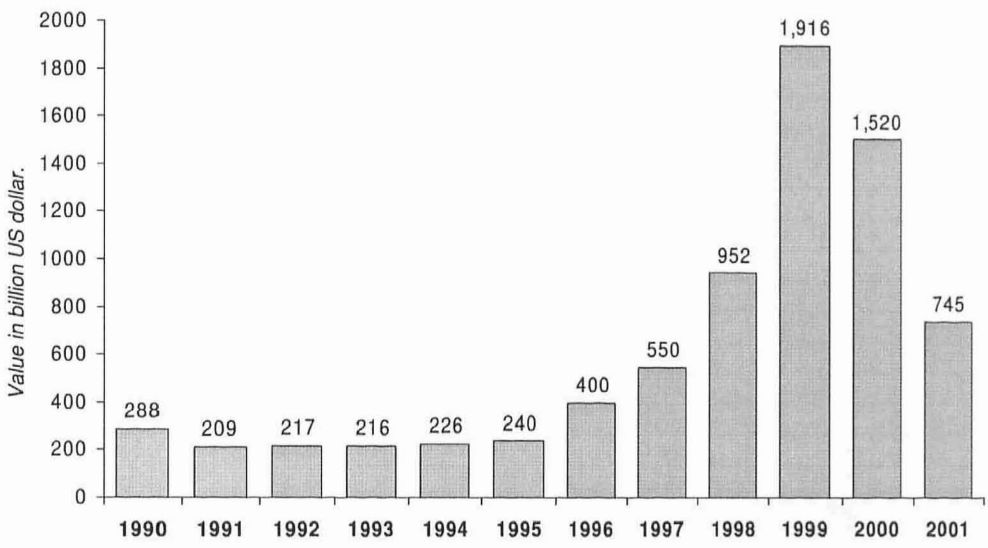
Parallel to the increasing number of European M&A's, the value of transactions increased significantly too. As Figure 11 illustrates, the total value of M&A deals was rather constant in the first 5 years of the decade hovering around $220bn before increasing to $340bn in 1995 and reaching a record of $1.95 trillion in 1999. The accompanied surge in multi-billion dollar transactions, also termed mega-mergers, which on a worldwide scale saw an almost quadrupling in the period 1996 and 2000, increasing from 45 multi-billion deals in 1996 to 175 deals in 2000

63 Steger et al. (2004) furthermore note that this is evident from previous M&A waves, where new production techniques, innovations in communication and innovative materials acted as initiators for M&As during the industrial revolution, now – during the information revolution - informational technology is having similar effects.

64 The first Wave was between 1897 – 1904, the Second Wave between 1916 – 1929, the Third Wave was between 1965 – 1969, the Fourth Wave was between 1981 – 1989, and the Fifth Wave started in the beginning of the 1990's and ended with 2000/2001 with the bursting dot-com bubble and the 9/11 attacks (Gaughan, (2002))

contributed to this phenomenon.[65] The increasing transaction values and the rising number of mega-mergers indicate that towards the end of the 1990s, consolidation was no longer restricted to smaller firms, but that more and more large firms were involved in restructuring and consolidating. The M&A boom in 1999 and 2000 was, however, followed by a dramatic slowdown in 2001 in line with the global economic recession and terrorist uncertainty. In 2001, while the number of transactions fell 33 percent to 3,749, the total value of M&A deals plummeted 51 percent to $745bn, which was the steepest annual M&A value decline since 1990 (Metwalli and Tang, 2003).

Figure 11: Changes in M&A value (in billion US dollars) in the EU 1990-2001



Source: Metwalli and Tang (2003)

All in all, the recent M&A wave saw a total of 40,151 M&A transactions in the EU which had a total value of about $7.6 trillion, also illustrated in Table 2. The transaction value for targets from the EU countries amounted to $6.06 trillion, roughly 80 percent, while the value for targets from non-European countries amounted to $1.55 trillion, or about 20 percent. Hence, the majority of Europe's M&A deals were either domestic or intra-EU.

The fact that firms from the UK were the most attractive targets with 41 percent of all deals and accounting for 27 percent of the entire transaction value for M&A's in Europe - more than the numbers of M&A deals made in France, Germany, Italy, Netherlands, Spain, and Sweden

65 Evenett, S. J. "The cross-border merger and acquisition wave of the late 1990's", *World Trade Institute and CEPR*, May 2002

combined, is astonishing.[66] Germany on the other hand, Europe's largest economy, saw very few deals compared to its size, indicating that German companies were not involved in a great deal of domestic roll-up and the German market did not appear as attractive to enter for foreigners. However, the large average transaction value indicates that the relatively few M&A deals in Germany involved large corporations.

Table 2: M&A transaction value in the EU by nationality of the target firm between 1990 - 2001

Country	Transaction Value in mln $ dollars	% of total	No. of deals	% of total	Avg. value p. deal in mln $ dollars
Austria	42,563	0.6	356	1	19.6
Belgium	162,328	2.2	589	2	275.6
Denmark	64,203	0.8	539	1	119.1
Finland	76,244	1	826	2	92.3
France	910,124	12	3,776	9	241
Germany	868,351	11.4	2,148	5	404
Greece	34,497	0.5	304	1	113.5
Ireland	52,544	0.7	662	2	79.4
Italy	727,002	9.5	2,110	5	345
Luxembourg	34,361	0.5	92	na.	374
Netherlands	339,634	4.5	1,221	3	278
Portugal	79,677	1	531	2	150
Spain	291,040	3.8	2,160	5	135
Sweden	302,181	4	1,565	4	193
UK	2,075,512	27.3	16,479	41	126
Subtotal intra-EU	6,060,261	79.6	33,358	83	181
Subtotal EU-global*	1,555,429	20.4	6,793	17	229
Total	**7,615,690**	**100**	**40,151**	**100**	**190**

Source: Metwalli and Tang (2003)

Generally, EU corporations have in the recent M&A wave been active on three fronts: in inter-EU consolidation, in intra-EU transactions, and in EU-global deals with particularly the US (Smith and Walter, 2003). Cross-border transactions, both intra-EU and EU-global transactions, accounted in this period for 26 percent of all M&A transactions, of which more than 2/3 (68 percent) involved US corporations being the target of EU acquirers. The rapid expansion of the US economy in the 1990s caused fears amongst EU firms of possible US protectionism that would interrupt their access to the US market. Consequently, many EU companies wanted to be physically present by

[66] A partial explanation for this phenomenon is most likely to be found in the UK's rather early privatization and liberalization of the economy during the Thatcher era, as well as Anglo-Saxon reliance on stock-market financing. While in the UK a great deal of companies are relying on stock-market financing, different conditions exist on the continent where many companies, including numerous very large ones, are not organized as publicly owned, limited liability corporations as they are in the UK and US. (Smith and Walter, 2003). Rossi and Volpin (2003) found another interesting explanation as their research showed that the volume of M&A activity is significantly larger in countries with better accounting standards and stronger shareholder protection. As the Anglo-Saxon markets are often believed to be at the forefront in these issues, this might partly explain the UK's lead in M&A's in Europe.

deploying more of their business activities into the US, predominantly done by acquiring or merging with US targets.[67]

Table 3 gives an interesting country break-down for the four largest EU countries, illustrating the value origin of M&A transactions. One should note that the total M&A values per country recorded in Table 3 are generally exceeding the values from the previous Table 2 as also non-European deals are recorded e.g. when a UK firm acquires a US company.

What is characteristic for all but one of the four countries is the high fraction of domestic M&A value. Interestingly though does Germany not follow suit here, having a relatively low share of domestic M&A value compared to a rather high share of transactions involving M&A's with foreign enterprises, indicating that domestic consolidation was not widespread. Though one has to be aware that these numbers are not recorded in absolute numbers, hence, the few very large mega-mergers, notably Daimler Benz and Chrysler, could have blurred these figures.

Table 3: M&A's completed in France, Germany, Italy, and the UK, 1990-2001
(M&A value in Millions of U.S. $)

France		
	M&A Value	%
Inter-French	626,132	42
French-foreign	567,124	38
Foreign-French	283,992	20
	1,477,240	**100**

Germany		
	M&A Value	%
Inter-German	391,298	28
German-foreign	525,307	38
Foreign-German	477,053	34
	1,393,658	**100**

Italy		
	M&A Value	%
Inter-Italian	536,734	64
Italian-foreign	112,179	13
Foreign-Italian	190,268	23
	839,181	**100**

UK		
	M&A Value	%
Inter-UK	1,354,428	42
Uk-foreign	1,093,264	35
Foreign-UK	721,084	23
	3,168,776	**100**

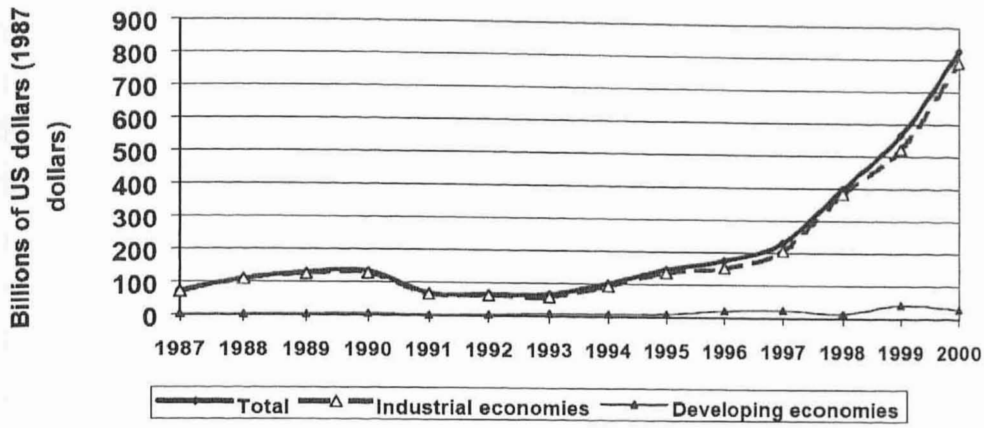
Source: Metwalli and Tang (2003)

As evident from Figure 12, the above-mentioned increase in cross-border transactions was increasing significantly subsequent to 1996, reaching a peak value of $828bn in 2000. Compared to the fourth M&A wave (1981-1990), cross-border M&A's only accounted for a maximum value of $135bn in 1990.[68] Hence, various academics point to this phenomenon as an indicator for the ongoing and increasing age of globalization (e.g. Dunning, 2002). What moreover is noteworthy

[67] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003
[68] Evenett, S. J. "The cross-border merger and acquisition wave of the late 1990's", *World Trade Institute and CEPR*, May 2002

from Figure 12 is the fact that developing economies contribute only a minute share to the overall cross-border M&A transaction value.

Figure 12: The latest M&A wave saw a significant increase in cross-border transactions



Source: Evenett (2002)

To evaluate how the consolidation wave has affected Europe's financial services industry and whether the trend of increasing cross-border activity could also be observed in there, I will in the following focus on this sector and review the consolidation activity more specifically.

7.2 M&A in Financial Intermediation

As mentioned before, the service sector was particularly active in the recent M&A wave, out of which the financial services industry was the most heavily involved as acquirers in European M&A transactions. Three of the top five most active industries (by value) were investment and commodity firms, banks, and insurance companies.[69] Likewise, financial services firms were often targets in Europe, with banks and insurance companies being among the top five most active seller industries.[70]

The major reason for financial institutions being extremely active in restructuring and consolidating is to be found in their poor and careless performance of the 1980s (Smith and Walter, 2003). In this decade most institutions experienced huge losses from mismatched assets and liabilities and from non-performing domestic and international loans. As a result, especially banks had to undergo a long period of internal restructuring to improve efficiency or alternatively joining

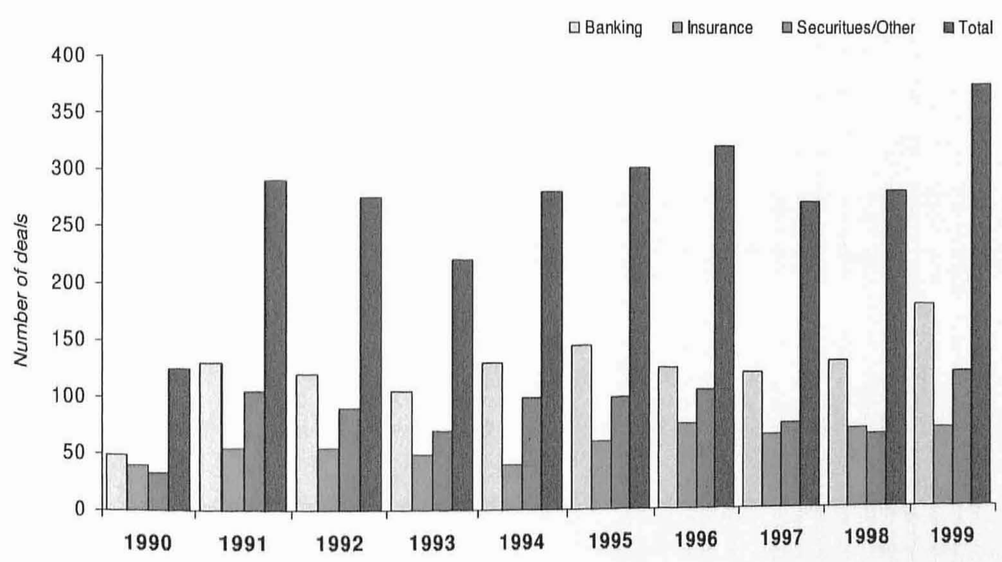
[69] The other two were telecommunications and electric, gas, and water distribution.
[70] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

forces by merging with other large banks in their own country to regain strength.

The Second Banking Directive, the Capital Adequacy Directive, and the Basel Accord were in this process particularly influential, as they required all banks to have the same minimum amount of capital, making it possible for pan-European competition between them to shift to the quality and cost of their services. In addition, especially banking was pressured by the stiffening competition and to offer a wider range of financial products to customers (Berger et al., 1999). This caused banks to strive for large size to better withstand competitive assaults from other banks in their home market and to be able to launch competitive attacks into neighbors markets. The result was a process of substantial consolidation within EU countries that has changed the European banking landscape tremendously (Buch, DeLong, 2001).

Figure 13 illustrates that the consolidation activity in the financial sector increased substantially after 1990, leveling at around 250-300 deals a year, before rising to more than 350 deals in 1999, indicating that the M&A hype in the end of the 1990s spill over to the financial industry. It is furthermore evident that banks were generally at the forefront of consolidating with about 60 percent of all deals involving the acquisition of a banking organization. The insurance industry was interestingly the least active segment in the consolidation process, constituting only about 15 percent of all transactions.

Figure 13: Sectoral overview of M&A's made by financial institution in the EU



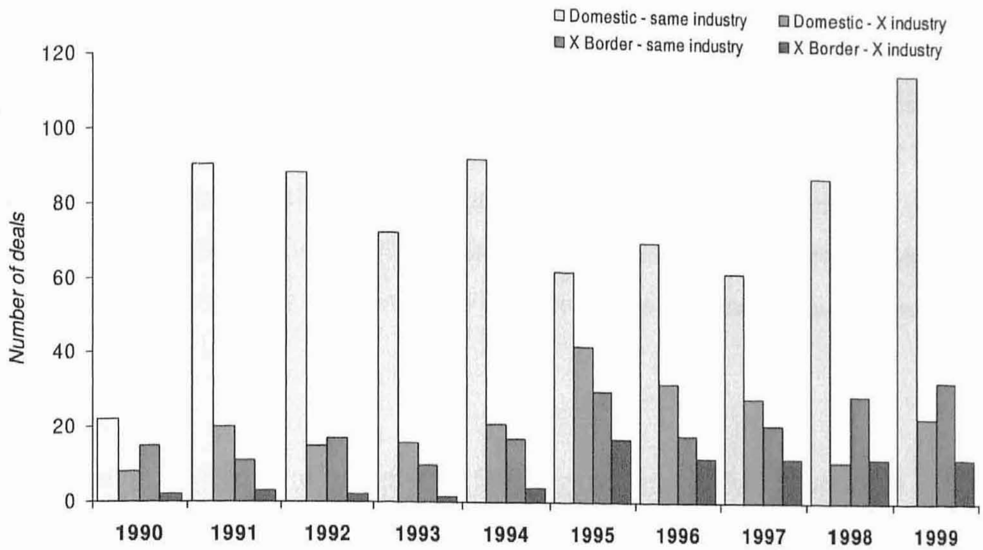
Source: Group of Ten, 2001
Note: Banking comprises commercial banks, bank holding companies, credit institutions, real estate mortgage bankers and brokers, and savings and mutual savings banks. Insurance includes both life and non-life insurance firms. Lastly, as the name indicates, the third group consists of securities firms, including investment banks, securities and commodities firms, and all other financial firms, such as exchanges.

In terms of transaction value a similar patterns occurs with banks being the largest sector, followed by securities firms and insurance companies. However, the Group of Ten (2001) found the dominance with which banks accounted for the transaction value particularly astonishing with 70 percent compared to about 11 percent and 19 percent for the securities- and insurance firms respectively. The sharp increase in average transaction value towards the end of the decade suggests that also in the financial sector more and more large institutions consolidated.

While consolidation in the beginning of the 1990s had the aim of gaining size, restructuring of basic businesses was gaining popularity, involving the streamlining of branch networks and upgrading and enlarging the services offered towards the end of the 1990s. In addition, more and more financial institutions were shifting the mix of its businesses, so that insurance firms and security firms were suddenly competing with similar products for similar customers as banks and vice versa. Nevertheless, the majority of restructuring was undertaken by banks that acquired, besides other credit institutions, insurance- and securities firms to enlarge their product variety according to the pressures of the universal banking principle. In addition, this seems to indicate that credit institutions generally had larger resources both in financial terms and in expertise of extracting synergies from cross-selling. Figure 14 indicates a slight trend of increased cross-industry activity, though this is only marginal compared to domestic-same industry deals. The same goes for cross-border deals. There is a slight increase in such transactions, though the majority remains domestic.

The Bank for International Settlements (BIS, 2000) notes that the preferences for domestic consolidation can be explained by the more obvious opportunities for reducing costs and fewer complications in terms of handling the integration of the entities due to a usually more homogeneous corporate culture, particularly in retail banking. Therefore, the few cross-border deals that were taking place in that time were predominantly between banking activities that had a global focus and similar organizational structure and corporate cultures such as investment banking and asset management.

Figure 14: Breakdown of EU Banking M&A's, 1990 - 1999



Source: Group of Ten (2001)

The gradually increasing amounts of cross-border deals in recent years indicates though that the focus on domestic restructuring and strengthening is approaching in several countries an end, as either no attractive targets remain or antitrust authorities prohibit a further domestic industry roll-up (BIS, 2000).

From Appendix G and Appendix H, which illustrate the concentration indices (CR5, the share of the five largest banks per country) as well as the Herfindahl index for 1997-2002, it is apparent that the concentration in Europe's banking sectors increased, albeit only gradually. The five largest institutions' share of total bank assets amounted to 53 percent in 2003 (on a non-consolidated basis), up from 46 percent in 1997. A similar trend is visible from the Herfindahl index, which rose from 383 in 1997 to 540 in 2003. Moreover, it generally appears that the banking market as a whole is relatively unconcentrated, however, both the CR-5 ratios and Herfindahl indices exhibit a fair amount of dispersion across the EU countries. Particularly the smaller countries, notably the Nordic countries and Belgium and the Netherlands, tend to experience a rather high degree of concentration due to the presence of a few large banks, indicating that domestic consolidation has progressed the furthest here.[71] As a consequence, financial institutions from particularly these countries engaged in some of the first large-scale cross-border deals (Nordea in the Nordic

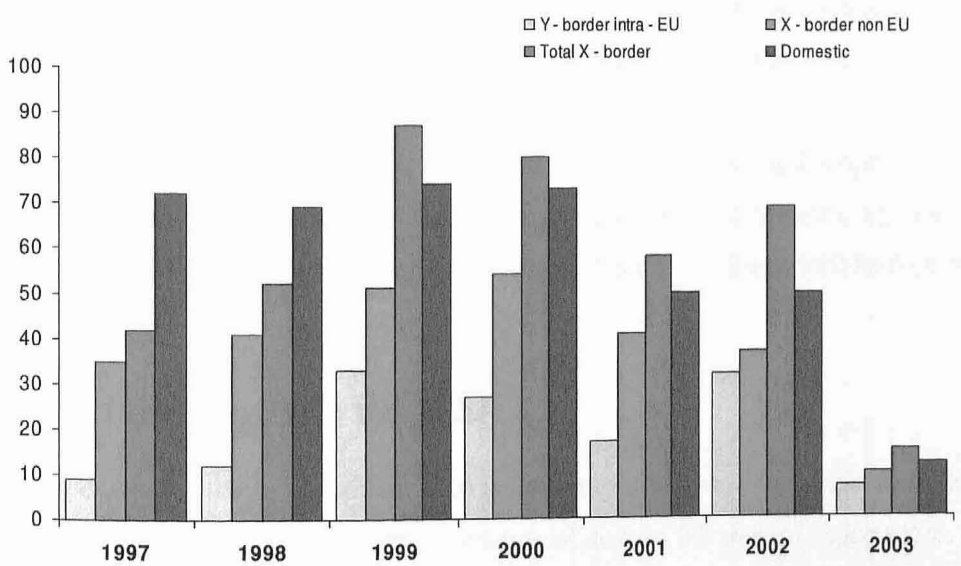
[71] "Report on EU banking structure", *ECB*, November 2004

countries and ING and Fortis in the Benelux states).

On the contrary, the large EU countries, notably Germany, France, the UK, and Italy, still have a very fragmented banking landscape with low CR5 ratios and Herfindahl indices. This indicates that particularly these countries can be expected to see greater domestic consolidation before greater cross-border consolidation activity in Europe will occur (Bikker, 2004). In addition, the low frequency and the relatively high uncertainty accompanied with high costs of cross-border deals can, according to Boot (2003) be explained by the fact that such transactions are typically viable only for relatively large universal banks, of which the greatest fraction are located in the four large countries.

Nevertheless, Figure 15 reveals that the frequency of domestic M&As seems to decrease in absolute number terms, while the amount of total cross-border deals seems to have increased, particularly in 1999 and 2000. Furthermore, this tendency of more cross-border transactions seems to stabilize, as also the years 2001, 2002, and the first quarter of 2003 saw more cross-border activity than domestic. As Mackintosh (2001) notes, "Domestic consolidation has now almost run its course, and the continent's biggest banks are looking abroad for future deals.[72]

Figure 15: Cross-border and domestic banking M&A's in Europe, 1997-2003 (absolute numbers)



Source: "Structural analysis of the EU banking sector – Year 2002", ECB, November 2003
Note: 2003 figures for the first 3 months

[72] Mackintosh, J. "Weathering the storms", *Financial Times*, June 27, 2001

However, Figure 15 makes it obvious that European banks were particularly keen on M&A deals with targets from outside the EU, particularly prior to 2002. This tendency seems however to be reversing, as intra-EU deals increased slightly towards the end of the period, while EU-global deals decreased slightly.

7.3 Conclusion

The above review showed that the 1990s saw an unprecedented activity in merger and acquisitions across all industries, though with the service sector being the most affected. Nevertheless, the majority of the consolidation activity was of domestic nature, with only gradually increasing activity across national boundaries. To that comes that a large fraction of the relatively low cross-border activity were so-called EU-global transactions, where particularly deals with US targets were widespread.

A similar pattern is also evident in Europe's financial industry, where the majority of all M&A transactions were of domestic nature. Nevertheless, several initiatives such as the SBD, CAD, and not least the EMU caused financial institutions from particularly the smaller EU Member states to look beyond national borders and engage in cross-border transactions. However, the frequency of such intra-EU deals is still very marginal; EU-global deals on the contrary, particularly between financial segments that have a global orientation and a similar corporate structure as e.g. investment banking, accounted for the greatest number of cross-border deals, with the US being the focus.

Consequently, the, what Davies calls, 'ultimate' test for an integrating European financial market seems therefore to have failed, as intra-EU activity is still rather infrequent, which is supported by Gjersem (2003) who notes that deep integration of financial markets is still far from being a reality.[73]

8 Part 3 – Motives for M&A's

Having examined the developments from the macro-perspective, it became evident that the measures taken by the EU to integrate its financial markets fell short of expectations. To better understand this 'lack of interest' in intra-EU transactions, I will in this section investigate the consolidation process from the firm- or micro-level perspective by looking at the motivating

[73] Gjersem, C. "Financial market integration in the euro-area", *OECD Working Paper* No. 368, October 2003

factors that drive consolidation at the ex-ante stage, and the ex-post consequences of transactions.

8.1 Ex-ante Stage - Motives for M&As

Many explanations have been supplied as to why firms engage in M&As, ranging from economic reasons to corporate learning and experimentation to emotional and psychological elements such as the hubris and ego of managers.[74] Yet, there is no consensus on theoretical explanations nor on the reliability of results from applied investigations.[75] Hopkins (1999) categorized the various explanations into four broad motives: 1) strategic motives, 2) market motives, 3) economic motives, and 4) personal motives.

Because the first three motives postulate that M&A's are pursued in order to maximize the value to shareholders of the combined company, they are also termed value-creating motives. The fourth motive by contrast, is a non-value-creating motive, at least for shareholders, as it suggests that managers of the acquiring and/or merging companies seek to maximize their own utility at the expense of shareholders, especially when their compensation is tied to the size of the company in terms of revenues or assets.[76]

In the following, I will review first the value-creating motives before I turn to the non-value-creating motives.

8.1.1 Strategic Motives

M&A transactions that aim at improving the strength of a firm's strategy are of strategic nature (Hopkins, 1999). The most frequently cited strategic rationales are synergy effects, which are either of static- or dynamic character (UNCTAD, 2000).

Static synergies include the pooling of management resources (one head office instead of two), revenue enhancement by using each others' marketing and distribution networks, purchasing synergies (greater bargaining power), cost reductions in production through the avoidance of duplication of production, R&D or other activities. Dynamic synergies on the other hand may involve the matching of complementary resources and skills to enhance a firm's innovatory capabilities with long-term positive effects on sales, market shares, and profits.

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[74] Morosini, P. "Are mergers and acquisitions about creating value?", in "Managing complex mergers" edited by Morosini P. and Steger U. *Prentice Hall Financial Times*, 2004

[75] Ietto-Gillies, G. Meschi, M., Simonetti, R. "Cross-border mergers and acquisitions: patterns in the EU and effects", available at www.merit.unimaas.nl/tser/teis021.pdf

[76] Morosini, P. "Are mergers and acquisitions about creating value?", in "Managing complex mergers" edited by Morosini P. and Steger U. *Prentice Hall Financial Times*, 2004

The increasing competitive pressures, falling prices, and excess capacity in the 1990s caused financial institutions, and particularly banks, to search for static synergies. The rapid developments in IT on the other hand triggered the importance of dynamic synergies pressuring financial institutions to offer more sophisticated products and products that exceeded the traditional competencies of banks e.g. insurance services. In addition, dynamic synergies made it possible to improve the service-level of banks by setting up an internet-banking infrastructure.

A dynamic synergy that specifically applies to cross-border acquisitions, although it partially belongs to the market motive discussed in the subsequent section, relates to the idea of 'national differences'. Morosini et al., (1998) found that the greater the cultural distance of countries in which merger partners are based the greater the benefits.[77] Therefore, cross-border transactions allow firms to locate different activities in places with appropriate mixes of locational advantages allowing these firms to realize the scope for rationalization and improving company performance by achieving an international specialization of the value chain (UNCTAD, 2000). The phenomenon of EU financial institutions engaging in cross-border transactions with US targets, mentioned briefly before, is a good illustration as it allows EU banks to acquire expertise and learn from the more advanced US financial market and vice versa.

Although synergies seem as a good reason to engage in consolidation particularly between horizontal transactions, Sirower (1997) argues that synergy effects rarely justify the premium paid by the acquirer, as "many acquisition premiums require performance improvements that are virtually impossible to realize even for the best managers in the best of industry conditions".

Another ubiquitous motive of banks to acquire other banks is to strive for monopolistic market structures, which allow them to extract economic rents from consumers or users of financial services and redistribute them to shareholders, cross-subsidize other areas of activity, or reduce pressure for cost-containment.[78] The related issue of large size and 'too big to fail' is discussed further in section 8.1.3.

Although strategic consolidation is a vital step leading to greater market power, eventually it is a superior product and service offering that ties customers to a particular financial institution. Therefore, consolidation leads to market power only by exploiting static and dynamic synergies wisely to improve the strategic position vis-à-vis competitors.

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[77] Though one should note that combining and making effective use of distant cultures is not an easy task and resulted in great problems and several failed acquisition attempts.

[78] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

The growing number of universal banks seems to be a case in point, as they, through continues M&As enhanced their branch network and exploit synergies to thereby achieve a better service offer and a larger product portfolio. However, at some stage the regulations prevent from too much market power.[79]

8.1.2 Market Motives

The market motive is particularly relevant for M&A activity that exceeds national boundaries, as it is a way to enter new markets.[80] Entering a new market is often triggered by a countries macroeconomic condition. A country with a higher economic growth rate, low unemployment, or an ageing population that is increasingly investing into pension funds are just a few examples of the many opportunities that can arise when expanding to foreign markets. Similarly, a general stock market undervaluation can be a good opportunity for acquirers to 'get hands' on an attractive target in another country at a 'bargain' price.

Acquiring already existing firms in foreign markets has become the fastest way for already established firms to get a foothold in a new country. The UNCTAD (2000) shows for example that M&A's are the most important method of foreign direct investment (FDI). Compared to the global overall M&A activity of $1.6 trillion, global cross-border deals had a value of $276bn in 1997, resembling not even 20 percent of global M&A value. Compared to global FDI, however, the value of cross-border M&A represented approximately 60 percent of all FDI inflows. Hopkins (1999) therefore suggests that cross-border M&As have become by far the single biggest means of integrating the world's economies.

When a market becomes deregulated, firms from other countries may see acquisitions of the formerly regulated or state-owned operations as the fastest way to gain a strong position in the new market. In addition, it is a way to gain entry without adding additional capacity to a market that already may have excess capacity. This appears particularly important in mature industries and markets, with banking being one of them. For example, HSBC's recent acquisition of a minority stake, 19.9 percent, in China's 'Bank of Communication' was an attempt to enter the promising

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[79] SEB and Swedbank abandoned a $5.2 bn merger in September 2002 that would have formed Scandinavia's second-biggest bank, after EU regulators objected to the combined bank's dominance of the Swedish banking market, implying that bank mergers have gone about as far as they can in Sweden.

[80] Other modes of entry include exporting, licensing, franchising, joint ventures, or wholly owned subsidiaries. While exporting, licensing, and franchising all have in common that they offer a low degree of control/risk, low need for resource commitment, and fast implementation, joint ventures, M&As, and wholly owned subsidiaries have in common a higher degree of control/risk and higher need for resource commitment. In addition, especially M&As offer more control than a joint venture and are faster to implement than a wholly owned subsidiary.

Chinese market and strengthen its foothold there.[81] Similarly, the Financial Times[82] reported recently that Deutsche Bank is vying with ING, to buy a stake of up to 25 percent in 'Bank of Beijing' in a deal that could be worth about $200m and give one of the foreign groups an important platform in China's capital. The Financial Times furthermore says that 'the interests by two of Europe's largest banks in a medium-sized Chinese lender underlines the country's growing importance to overseas financial groups seeking to capitalize on the country's rapid economic growth and rising wealth'.

Unlike other industries, e.g. telecommunications, it is though interesting to note that the deregulation of financial services in the EU did not see a widespread rush for cross-border deals. A partial explanation for this phenomenon is to be found in the before-mentioned greater domestic fragmentation compared to telecommunications upon deregulation. While the telecommunication industry was grapping the chance in acquisition frenzy, Europe's financial institutions were struggling to roll-up the domestic market first.

8.1.3 Economic Motives

Economic motives for M&As include many important reasons related to economies of scale and scope. These motives generally suggest that a firm is able to decrease costs by increasing the volume of output of products and services it produces.

The financial services industry should have, due to its very information- and distribution-intensive characteristics, abundant potential for economies of scale. Similarly, diseconomies of scale should be prevalent by arising with disproportionate increases in administrative overhead, management of complexity, agency problems, and other cost factors related to increases in firm size.[83]

Closely related to economies of scale are economies of scope (Walter, 1999), which are competitive benefits to be gained by selling a broader range of products, resulting in cost savings through sharing of overheads and improving technology via joint production of generically similar services.[84] Moreover, economies of scope can impact a firm's revenue when the cross-selling of multiple financial services products makes it cheaper[85] for the buyer to purchase them from one

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[81] Sun, M. "China's banking industry enters global integration", *China Daily*, December 20, 2004

[82] Guerrera, F. "Deutsche in talk to buy Bank of Beijing", *Financial Times*, January 17, 2005

[83] Smith, R. C. Walter, I. "Global Banking", *Oxford University Press*, 2nd edition, 2003

[84] Diseconomies of scope arise from such factors as inertia and lack of responsiveness and creativity that may come with increased firm size and bureaucratization, 'turf' and profit attribution conflicts that increase costs and erode product quality in meeting client needs, or serious cultural differences across the organization that inhibit seamless delivery of a broad range of financial services

[85] including the cost of the service, plus information search, monitoring, contracting and other transaction costs

instead of several suppliers.[86]

Although objective measuring of scale and scope economies is rather difficult for financial services, as Boot (2003) notes, various studies have been conducted on this issue. For example have Shaffer and David (1991), Cornett and Tehranian (1992), Mester (1992), Mitchell and Onvural (1996) and Clark (1996) and Berger, Demsetz and Strahan (1999) all found no evidence for scale economies in financial services, though with the exception of relatively small banks with total assets ranging between $100 million and $10bn. In an interview with The Banker, Ingo Walter, who is a professor at the Stern School of Business, said "There have been about 55 studies into this and there is no evidence of economies of scale in large mergers."[87]

Similar to economies of scale, consistent empirical evidence has illustrated that scope economies are an elusive objective when it comes to consolidation, note Berger and Humprhey (1997) and (Berger, Demsetz, and Strahan (1999). Nevertheless, Smith and Walter (2003) suggest that revenue economies of scope and scale may indeed exist, but that these are likely to be very specific to the types of services provided and the types of clients served. Therefore, while economies of scale and scope are certainly relevant and applicable to most industries, the validity of this motive for the financial services industry in general seems questionable.

Another economic motive which is often cited to justify M&A's is related to the size of a company. In a globalizing economy, greater size can be a crucial parameter, as size in itself can serve as an inhibiting factor that prevents from being taken over and, therefore, can have a protective function (UNCTAD, 2000). Particularly for banks the common notion "too big to fail" ensures that in case of financial problems, a "too big to fail" bank can rely on the government to be bailed out in order to avoid possible bank runs. Consequently, the strategy to reach a "too big to fail" size allows all uninsured liabilities to have de facto insurance coverage and hence maximizes the value of the implicit guarantees received from the government (Penas and Unal, 2001). Not surprisingly then do bankers regularly argue that 'bigger is better' from both systemic and shareholder value perspectives[88], as such banks can engage in riskier activities while in the same time being certain that they will be saved in case something goes wrong – which dates back to the moral hazard problem. In addition, the larger a bank grows, the greater its (indirect) political

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[86] Diseconomies of scope could arise through agency costs that may develop when the multi-product financial firm acts against the interests of the client in the sale of one service in order to facilitate the sale of another, or as a result of internal information transfers considered disadvantageous to the client's interests.

[87] Piggott, C., Will They Be Happy? *The Banker*, Vol. 150, No. 898, December 1, 2000.

[88] Walter, I. "Financial services strategies in the Euro-zone", *European Management Journal*, Vol. 17, No. 5, 1999

influence will grow, which can be an interesting feature for some CEO's, leading me to the discussion on non-value maximizing motives.

8.1.4 Personal Motives

The last general cause identified by Hopkins are the personal motives (or the behavioral explanation) which argues that corporate managers operate in their own self-interest, especially where corporate governance is weak (a manifestation of what economists have denoted the "principal-agent" problem[89]) when pushing through a transaction. M&As can therefore serve as means of "empire building" to enhance executives' power, prestige, job-security or remuneration, even when this is not technically efficient or in the interest of shareholders (Baumol, 1967). Similarly, management hubris or ego as well as what Bower (2001) refers to as 'bluefish phenomenon' or 'herd effect' are other motives that can drive managers to engage selfishly in transactions where the economic benefits appear rather abstract. The M&A hype towards the end of the 1990's saw, despite the severe overvaluation of the market, particularly many transactions, which to a certain extent can be related to personal motives (UNCTAD, 2000).

While all of the above-mentioned factors are important to consider when explaining why firms undertake M&A's, it is seldom only one of the four broad categories that is decisive. In fact, in a cross-national comparison, testing several of the motives for M&As, no examined hypothesis received consistent confirmation, suggesting that there are multiple reasons simultaneously at work (Mueller, 1980). To put it in Scherer and Ross' (1990) words: "Mergers occur for a myriad of reasons, and in any given case, several different motives may simultaneously influence the merging parties' behavior."

Although not explicit, most of the above-described motives seem to speak in favor and explain the large degree of domestic consolidation when applied to Europe's financial services sector. Synergies are more obvious and easier to exploit when consolidating domestically and across industries, becoming 'too big to fail' is an ambition that needs to be undertaken in the domestic market, and the general fragmentation of the banking industry, which though has decreased slightly as section 7.2 showed, called for domestic consolidation. Hence, few obvious motives indicate clear benefits for expanding abroad while there are still numerous opportunities in the home market to exploit. Countries where domestic consolidation has advanced relatively far

[89] The agency problem refers to the fact that if an agent is hired to represent an owner, the two parties will have conflicting interests. Managers are interested in the things that give them more power and more security, such as growth, size, and diversification. The owners, on the other hand, are interested in profitability, stability, and increases in the stock price.

caused though that these domestic opportunities have vanished causing financial institutions to increasingly look for opportunities beyond national boundaries e.g. Danske Banks recent acquisition of Northern Bank in Northern Ireland and National Irish Bank in the Republic of Ireland.

8.2 Ex-Post Merger Stage - Integration

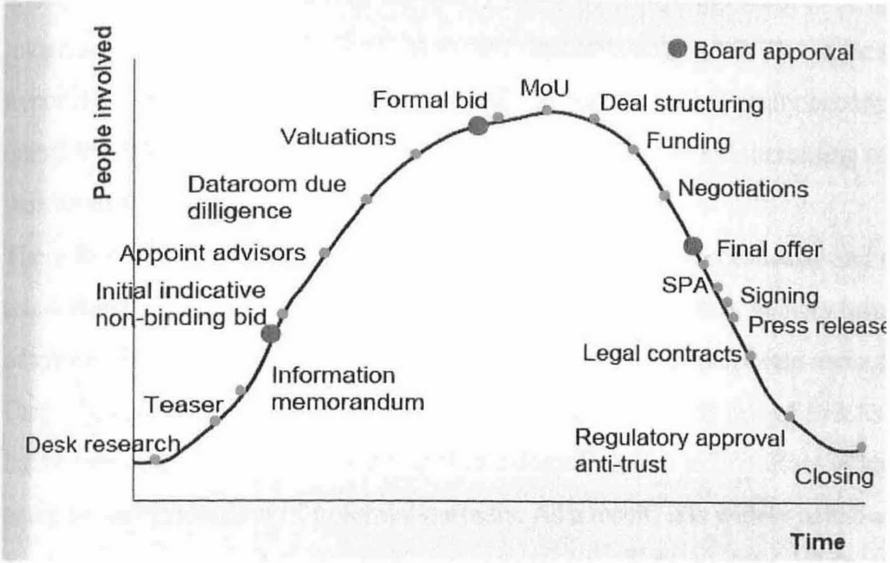
Except for personal motives, which are a rather special category, the value-maximizing motives for consolidation generally assume some sort of strategic fit, which can broadly be defined as similarity between organizational strategies or complementary organizational strategies that are believed to create value of some sort to the enterprise. Although Chatterje *et al.* (1992) [90] note that there is no clear evidence between financial performance and strategic fit in mergers, it seems nevertheless intuitive that strategic fit plays an important role in the ex-post stage of most M&A transactions. On the other hand, assuming that most transactions meet the strategic fit criterion, it is surprising that more than 60 percent of all M&A's fail to live up to the announced expectations, and either end up destroying shareholder value or do not deliver improvements to the ex-ante situation, according to Mercer.[91] Carleton (1997) supports this finding, showing that between 55-70 percent of all deals fail to meet the anticipated purpose communicated to shareholders. The Economist said therefore in July 2000: "A stream of studies has shown that corporate mergers have even higher failure rates than the liaisons of Hollywood stars".

One explanation of these high failure rates can be related to the actual planning and execution of M&A transactions. Figure 16 gives an illustration of people involved in the different phases of a typical M&A transaction. What is prevalent is that the greatest number of people - typically members of the corporate management - is concerned with the actual deal structuring, while the ex-ante and ex-post stages receive less attention and involve fewer people. It is widely acknowledged that the ex-ante stage, concerned with analysis of strategic- and cultural fit, is a crucial parameter in the M&A success, however relatively few people are involved in this process. Similarly, the decreasing number of people working at the ex-post stage, despite the often vast number of affected people – both as change agents and change subjects – is likely to impact the integration and success of the transaction. Parallel to that, the attention of management is often

[90] Chatterjee, S., Lubatkin, M., Schweiger, D. & Weber, Y. Cultural differences and shareholder value in related mergers: Linking equity and human capital. *Strategic Management Journal*, 1992, 13, 319–34.
[91] Mercer Human Resource Consulting, "Transatlantic mergers and acquisitions – a success story", 2002, www.mercerHR.com

turning away as soon as the contracts are signed, perhaps to other M&As, assuming that the most important part is done, and that integration will not pose a problem.

Figure 16: Steps in the M&A process and number of people involved



Source: Guest lecture during my exchange term at the ERASMUS University by Jacqueline Lommen, "A glimpse behind the scenes – M&A practice within a leading international insurance group" Aegon Business Development Group, ERASMUS University, December 8, 2003
Note: MoU = Memorandum of Understanding, SPA = Sales and purchasing agreement,

The 'being-left-alone' situation subsequent to the deal structuring, has therefore received considerable attention and it is widely acknowledged as being the prime source for M&A failure (e.g. Birkinshaw et al., 2000; Buono and Bowditch, 1989; Gertsen et al., 1998; Greenwood et al., 1994; Ingham et al., 1992; Nahavandi and Malekzadeh, 1988; Olie, 1994; Shrivastava, 1986). Also Pablo (1994) notes that academia is demonstrating an intensified interest in examining the human or cultural facets of M&A's following the failure of traditional explanations to provide adequate explanations for these great failure rates.

Vaara's (2003) in-depth analysis of internal decision-making at the upper echelons of the integrated organization points to four specific factors of the post-acquisition process, which are often likely to form impediments to effective organizational integration: inherent ambiguity, cultural confusion, organizational hypocrisy, and issue politicization, which to some extent result from the dissatisfactory planning at the ex-ante stage.

Subsequent to an agreed transaction considerable ambiguity can be expected concerning the roles of the different units and the changes needed to pursue integration, which is an indication that these issues are forgotten or neglected during the structuring the deal. Consequently, this ambiguity creates impediments to effective integration, but can also be seen as a major cause of other 'irrational' features of post-acquisition decision-making. One reason why the concrete discussions concerning integration issues are often neglected is because they are likely to be plagued by cultural confusion, misunderstandings and resistance – the second reason - thereby underpinning ambiguity. Third, especially when the companies seem to be operating successfully, integration issues are easily 'lost' in routine decision-making, which can be seen as 'organizational hypocrisy'. And fourthly, over time, specific integration issues easily become politicized questions, leading to the strengthening of internal divisions and increasing confrontation between various units within the organization.

These four 'irrationalities' are, according to Vaara (2003), theoretically and empirically intertwined - though they basically origin from the same source, namely bringing together people of various backgrounds, social identities, and cultures, both corporate and national. Also Cartwright and Cooper (1993) suggest that the dismal success rate of M&As can be attributed to incompatible cultures, hypothesizing that culture fit is just as important as structural fit in the analysis and evaluation of potential partners. As a result, it is widely acknowledged that cultures can be a make-or-break factor in the merger equation.[92] Cartwright and Cooper (1993) concur saying that financial benefits anticipated from M&A's are often unrealized because of incompatible cultures.

Not surprisingly then did many researchers draw attention to the cultural differences in organizations as major causes for organizational problems when studying cross-border acquisitions (Altendorf, 1986; Nahavandi and Malekzadeh, 1988; Sales and Mirvis, 1984; Walter, 1985, Calori et al., 1994; Gertsen et al., 1998; Olie, 1994; Very et al., 1997; Weber et al., 1996)[93].

Particularly national backgrounds and identity are likely to unite and divide managers in the case of cross-border acquisitions, as illustrated in studies in this field not least because they often create specific problems in terms of communication and understanding (Gertsen and Söderberg, 1998). As a consequence, M&A's occur more frequently between partners with a close geographic proximity as such countries are often believed to share similarities in terms of culture, note Buch and DeLong (2001), because sharing a common language is likely to lower the costs of melding two corporate cultures since information needs to be communicated in only one language.

[92] See for example Giffin, A. F., Schmidt, J. A. "Why HR can make or break your M&A", Tillinghast-Towers Perrin, 2002 available at: http://www.towersperrin.com/tillinghast/publications/publications/emphasis/Emphasis_2002_2/2002052308.pdf

[93] For a more detailed review of the importance of culture consult e.g. Buono et al. (1985), Cartwright and Cooper (1993), Gordon (1991), Hofstede et al. (1990), Schraeder and Self (2003). Several of these researchers that adopt a cultural perspective have focused on the complex cultural integration processes that follow acquisitions.

As a result, some researchers have gone as far as using cultural differences as an explanation for post-acquisition financial performance, the argument being that greater cultural differences create more problems and, ultimately, lower profits and weaker market performance (Chatterjee et al., 1992; Datta, 1991). On the contrary, Krishnan et al., (1997) found that cultural differences can also be a source of value, which Morosini et al. (1998) supports by showing that in the case of cross-border M&As, large cultural differences between bidder and target companies have been found to be positively related to acquisition performance in terms of sales growth.

The before mentioned EU-global cross-border deals that occurred in the financial sector are a case in point. These deals were mostly involving firms in the wholesale banking industry, i.e. investment banking, which have a global orientation and therefore often a diverse set of national cultures employed. Nevertheless, the corporate culture between target and acquirer were rather similar, thereby making the integration of these entities relatively easy compared to e.g. retail banking operations were both national cultures and corporate cultures are more distinctive.

8.2.1 Integration and Corporate Strategy

The above discussion illustrated that the ex-ante stage of determining motives and evaluating strategic- and cultural fit influences the ex-post integration success of M&As, while in the same time recognizing the doubly complexity of cross-border deals. That the corporate strategy in this process is a decisive factor for particularly cross-border M&As seems therefore evident.

Although no previous work exists on linking the strategy orientation of firms to the ex-ante and ex-post stage of M&As, at least I am not aware of any, a potentially useful way of doing that could be by means of the Integration-Responsiveness framework (IR-grid).[94] The IR grid has been used extensively in the international business literature to identify the diverse and often-conflicting pressures confronted by firms as they expand their activities worldwide. The underlying question is whether firms should be responsive to the local environments in which they operate and adapt their operations at the cost of efficiency, or should they standardize their 'response' globally and thereby improve efficiency, or find a middle way.

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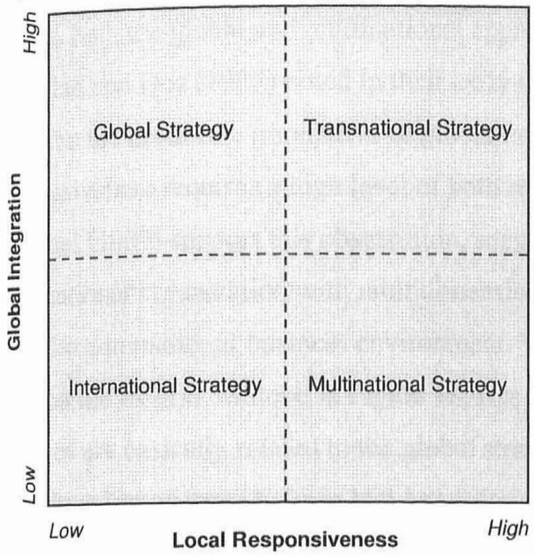
[94] The integration-responsiveness (IR) framework of Prahalad and Doz (1987) grew out of earlier evolutionary theories of the development of multinational enterprises (MNEs) (e.g., Perlmutter, 1969; Stopford and Wells, 1972; Vernon, 1966). The previous models, although being popular, had limitations due to their neglect of the global business environment—in particular the many technological, market, competitive and governmental factors that affect the companies. As a result, these models provided very simplistic solutions to complex problems in multinational organizations (Bartlett, 1986). In response to this omission, a number of authors reformulated the classic differentiation and integration approach of Lawrence and Lorsch (1967) into the IR framework that is recognized today.

Figure 17: The IR-grid



Source: Prahalad and Doz (1987)

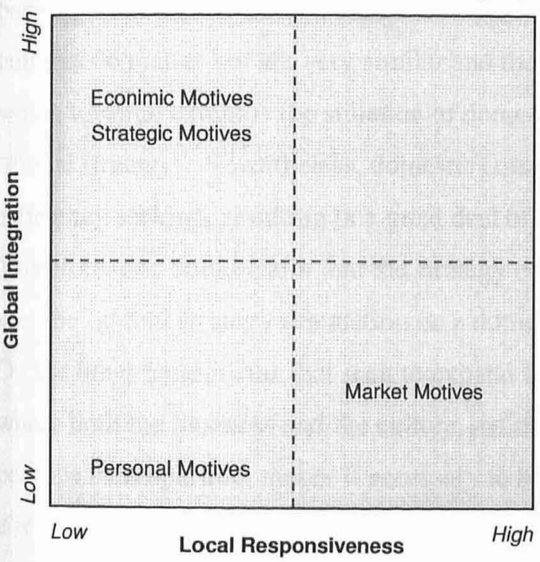
As Figure 17 illustrates, the IR framework leads to a simple categorization of corporate strategy orientation for firms conducting business in more than one country. The international strategy is used by firms that operate in an *international* environment by exporting goods from a home base. The pressures for efficiency and adapting to local customs are both low, as the focus is to exploit home-country innovations. While this approach was rather successful in the past, this strategy can not withstand today's pressures for flexibility and efficiency (Bartlett, Ghoshal, and Birkingshaw, 2004)

Firms that operate in a multinational environment differentiate their products and services in response to national differences in customer preferences, industry characteristics, and government regulations. As a consequence, subsidiaries are treated as autonomous entities, making them unusually flexible and responsive to local needs. The price for this flexibility is the inevitable inefficiency of various autonomous units.

Companies adopting a global strategic approach focus primarily on developing global efficiency by centralizing operations, to achieve the best cost and quality position for their products. In turn, the focus on efficiency causes decreasing flexibility in terms of responding to local needs.

The optimum strategy for firms being present around the globe appears to be the transnational approach. The aim is to simultaneously achieve global efficiency and local responsiveness on a worldwide scale. And while the global approach calls for centralization of activities to exploit scale economies, and the multinational strategy calls for decentralization to remain flexible to local needs, the transnational strategy is more differentiated by locating key resources and capabilities at home, while other activities are located where the greatest benefits in terms of flexibility and efficiency can be obtained. Unquestionable, this results in a more complex corporate configuration than in both the global and multinational approach (Bartlett, Ghoshal, and Birkingshaw, 2004). Prahalad and Doz (1987) noted in their early study that in more and more industries, the balance between the economic imperative of global integration and the political imperative of local responsiveness requires a high level of both in the form of a transnational strategy. Bartlett and Ghoshal (1989) support this observation, suggesting that successful MNEs are those that create a transnational organization with multidimensional capabilities in order to withstand the increasingly complex international business environment. When projecting the motives, discussed in section 8.1., on the IR grid, as done in Figure 18, it is prevalent that both strategic motives and economic motives are basically related to the global strategy, as they are mainly concerned with extracting efficiency improvements from M&As.

Figure 18: M&A motives projected on the IR-grid, 'motive-strategy grid'



Source: Own illustration

The market motive on the other hand is about entering new markets where the objective to actively respond and adapt to the local market conditions is essential. The personal motive is rather special in this respect and difficult to classify, though it seems that it neither faces pressures to create efficiencies nor to respond to local customs, which is the reason for placing it in the lower-left corner.

From this conceptualization, I will term it the 'motive-strategy grid', it can therefore be derived that different motives for M&As require different strategies in order to successfully realize them. This is however complicated by the before-mentioned interrelatedness of motives and the frequent presence of several motives when engaging in M&As. Nevertheless, as motives can generally be categorized as either being efficiency-seeking or market-seeking, one prime motive should in most case be identifiable.

The EU-global cross-border M&As that involved predominantly the wholesale segment of banking, e.g. investment banking, were generally caused by economic and/or strategic motives as the rational behind them was most probably to increase efficiency. The 'motive-strategy grid' in Figure 18 therefore indicates that the global strategy orientation appears most suitable. In spite of being across national boundaries, the global orientation of the business and similarities in corporate culture made the global strategy orientation viable, as the need to respond to local peculiarities was very low.

To successfully pursue a global strategy orientation and realize the strategic and/or economic motives for an M&A can happen in two different situations. 1) It requires a situation where national cultures do not matter much because the business has a global orientation with uniform corporate structures and values, similar to the above example of cross-border deals in wholesale banking, making the integration relatively simple. Alternatively, 2) it requires a situation where cultures do matter but are very similar and thereby do not pose a major problem when integrating, which to some extent is the situation of domestic consolidation, which though conflicts the name 'global strategy'. Nevertheless, domestic consolidation activity is particularly in banking efficiency seeking, resulting in a great deal of centralization, rationalization, and streamlining. Therefore, one could claim that the strategy orientation banks followed in domestic consolidation was the 'global strategy orientation on a domestic scale'.

On the other hand, firms that seek to expand their business to foreign markets and are in a situation where both the business and the culture, national and corporate, are very different, new, and perhaps incompatible, makes it necessary to be flexible and respond and adapt to these local circumstances e.g. through a decentralized structure, granting autonomy. Therefore, the multinational strategy, or ideally the transnational strategy, orientation seems in this situation to be superior.

From a theoretical point of view, the various measures undertaken by the EU to integrate Europe's financial markets could indicate that particularly for the banking industry, an almost homogeneous European market structure exits, making the necessity to respond to local peculiarities obsolete. In such a homogenous EU market, where it would not matter to companies whether transactions are cross-border or intra-EU as it is one Single Market, the main strategic focus would then automatically be on exploiting efficiencies, hence, the IR grid would indicate the global strategy as being the most viable. Nevertheless, despite the measures to create a single market, I have shown earlier that the EU is still far from an integrated financial market, and it can for the time being not be anticipated in reality that customer needs and market conditions will converge to an extent that

treating the EU market as a Single Market that makes responding to national differences obsolete. Therefore, for companies operating across the EU a multinational or ideally a transnational strategy orientation will be necessary in order to successfully deliver on the M&A promises.
In section 9.3.2.5 I will assess whether the concept of the 'motive-strategy grid' is applicable in reality, based on the analysis of the two case studies.

8.2.2 Value enhancing vs. value destruction

As mentioned earlier, the main driver behind M&As is – or should be - the objective to create value for the acquiring corporation and their shareholders. Hopkins (1999) concluded recently: "There seems to be clear evidence that mergers and acquisitions often fail. Nevertheless, this depends on how one defines failure. If failure is used in an extreme sense, such as the sale or liquidation of the business, then the rate of failure is relatively low. If failure is the lack of attainment of management's financial objectives, then the rate of failure is high."
To estimate and evaluate the performance of merger-related gains there are generally two approaches. The first approach is to evaluate the pre- and post-merger performance by means of the stock market reactions, done in event studies. [95] Proponents of this approach argue that market data and the market reaction is likely to be a better indicator of the real economic effects of the announced deal, compared to the second approach of comparing accounting data, because it more accurately conveys the implied value of merging two independent entities.[96] A study by Sirower (2002/3, EBF) seems to support this notion as he finds that initial investor reactions, which are based on previous expectations and the new information given by the company about the economic wisdom of the transaction, are powerful forecasts of the future. Furthermore, he finds that the first year of an acquisition is critical to deliver performance promises because it signals the credibility of those promises. Therefore, he believes that the ex-post M&A performance is a persistent

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[95] Only the event study methodology allows a direct judging on the value implications of a bank merger and/or acquisition, (Pilloff and Santomero (1998)) as they examine the stock market reaction to a merger announcement, i.e. whether investors believe it will create or destroy value. Event analysis assumes information-efficient markets, which means that the market price is very sensitive to new information will be incorporated into the price immediately after it has been made public. The stock market reaction is then measured by abnormal returns which are the difference between the expected price without the event and the actual price. The advantages of stock price data is that it is easily available, the calculations are straightforward and it does not rely on potentially misleading accounting data. But there are many problems with event studies. Firstly, the results depend highly on the length of the time window abnormal returns are computed for and the time base since the market often anticipates acquisitions long before the actual announcement day. The leakage of information prior to the announcement may also play a role here. Secondly, it is difficult to select a reasonable benchmark in a rapidly consolidating industry. Thirdly, this method assumes efficient markets that immediately incorporate new information and relies on the assumption that the market expectations are a good predictor of the long-term effects of an event.
[96] Pilloff, S., Santomero, A.M., "The Value Effects of Bank Mergers and Acquisitions", *Wharton Financial Institutions Center*, 97-07

function confirming the initial perceptions of investors through rapid delivery or non-delivery of results.

Sirower's findings are therefore conflicting with most other researchers (see section 9), who acknowledge that the great complexity of integration in particularly for cross-border transactions, might take several years before benefits can be exploited.

The second approach of evaluating the performance is predominantly based on accounting data. By comparing the ex-ante and ex-post M&A performance lets one determine whether consolidation leads to improvements in reported costs, revenue or profit figures. The strengths of this method is that accounting performance can be directly measured and compared as data is easily obtained from e.g. annual reports. However, there are several drawbacks with this measure such as the fact that the accounting data is based on historical figures and hence neglects market values and market outlooks. In addition, changes in performance may not be solely due to the M&A but instead due to other events that might have occurred which accounting data may not accurately account for and therefore may lead to improper conclusions regarding merger related changes.

Regardless of the approach chosen to evaluate performance, there is no consensus whether or not M&As create value. Berger, Saunders, Scalise, and Udell (1998) note for example that bank mergers, on average, neither create value, nor destroy stockholder value, while Houston, James, and Ryngaert (2001) found that announcements of certain types of bank mergers do create value, e.g. ones hat are predicted to reduce costs. What academia, researching on M&A performance, seems to agree on is though that shareholder returns for target companies are often positive (Delong (2001), Beitel et al. (2002)) at the expense of the bidders shareholder return (Kane (2000), Cornett, Hovakimian et al. (2000), Pilloff (1996), Siems (1996), and Hudgins and Seifert (1996)). In the longer-run however, Houston et al. (2001) and Beitel et al. (2002) find that that the combined entity see positive, although small, shareholder returns.

While the above studies are mostly based on US data, studies that focus on the EU seem to reveal different patterns. Beitel and Schiereck (2001) for example found after analyzing transactions between European financial institutions between 1988 and 2000, that domestic (inter-EU) M&As on average have significantly positive combined (bidder plus target) announcement effects, which though became weaker towards the end of the period). Furthermore, they found that domestic cross-industry transactions (particularly between banks and insurers) have on average a positive value impact, which is also confirmed in other European studies on cross-industry deals between banks and insurer; e.g. Cybo-Ottone and Murgia (2000) who find a positive effect on combined value. Smith and Walter (2003) explain the positive effects from combining commercial banking with insurance activities by the fact that the greater diversification of income from multiple products, client groups, and geographic areas creates more stable, safer, and ultimately more valuable institutions.

When looking more specifically at the value effects of cross-border transactions, Hudgins and Seifert (1996) for example find no significant difference between US banks acquiring domestic banks and those acquiring foreign banks. In addition, they also do not find a significant difference between US banks being acquired by domestic or foreign banks. Altunbas et al. (2004) study on US-data shows improvements in performance after mergers have taken place, particularly in the case of cross-border M&As. The study by Lowinski et al., who analyzed the wealth creation of M&As in the Swiss capital market and placed special emphasis on the peculiarities of cross-border transactions, found no significant difference in wealth creation between domestic and international merger activity.

Bühner (1992) on the other hand, who examined announcement effects to bidders in the German capital market from a long-term perspective, found a negative stock price reaction during the first months after the merger announcement, which however turned positive after 24 months. Gerke et al. (1995) found though no evidence of significant announcement effects for cross-border mergers in Germany from a short-term perspective, and Corhay and Rad (2000) come to similar conclusions for cross-border acquisitions of Dutch firms. On the contrary, Morosini (2004) found that the higher the national cultural distance between the acquirer and the target company, the better the performance results. Richard Coleman, bank analyst at ABN Amro, says though that 'cross-border consolidation will happen eventually […] but how it creates value is difficult to see.'[97]

The ambiguity whether of not value is created subsequent to M&As sheds therefore a dubious light on the entire reasoning of engaging in such transactions and in addition underlines the fact that integration is an important issue to ensure value creation. In addition, there seems to be no empirical evidence that clearly indicates the superiority of domestic transaction compared to cross-border deals in terms of value creation.

8.3 Inhibiting Factors to wider Cross-Border Transactions

Inhibiting factors that can explain the marginal frequency of intra-EU transactions in Europe are

[97] Mackintosh, J. "Weathering the storms", *Financial Times,* June 27, 2001

various and can be rather idiosyncratic, which is the reason why I will only focus on some of the major factors.

It is for example acknowledged that government intervention in Europe appears to be one of the main obstacles, by favoring the emergence of domestic champions (Boot, 2003) particularly when it concerns so-called 'strategic' industries such as utilities, airlines, and in particular banks and financial institutions. This has meant that governments have favored transactions among large domestic banks and have been opposed to foreign banks acquiring large domestic banks. These policies have suppressed cross-border M&A not only directly but also indirectly by delaying the onset of the point at which domestic banks have felt that they could no longer grow at home and would, instead, have to grow abroad.[98] Also the European Commission acknowledged this phenomenon, saying that "one of the reasons for banks' failure to consolidate extensively on a cross-border basis may be partly due to the intervention of national authorities".[99]

'Golden' shares[100], which were widely used in the EU, resembled such a protective mechanism against cross-border acquisitions.[101] Another example of direct government intervention to cross-border transactions was France's bail-out of Alstom to avoid the take-over attempts of German conglomerate Siemens.[102] As a consequence, acquiring a 'strategic' target is very difficult; first when it becomes too inefficient and weak and no other way of rescuing it exists, national authorities tend to prevail and agree to foreign ownership.

Another inhibiting factor could be related to evidence found by Tschoegel (1987) and Dufey and Yeung (1993), indicating that for markets that are well-developed and competitive there is no reason to expect foreign banks in general to be better than local banks at retail banking. The aggregate data supports the argument that when investing in already competitive retail banking markets, foreign banks have no advantage. Miller and Parkhe (2002) examined the banking sector in 14 different countries and found domestic banks to be more 'profit efficient' than foreign banks. Also Demirguec-Kunt and Huizinga (2001) and Claessens et al. (2001) found that foreign banks

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[98] Tschoegel, A. E. "Discussion" on Buch C.M. and DeLong, G. contribution "Determinants of cross-border bank mergers, is Europe different?", in Herrmann, H. and Lipsey, R. "Foreign direct investment in the real and financial sector of industrial countries", *Springer*, 2003

[99] "Cross-border mergers and acquisitions in the banking sector: follow-up to Scheveningen informal ECOFIN", European Commission - DG Internal Market and Services - Banking Advisory Committee, December 2004

[100] Golden shares are a technique that gives its shareholder veto powers over changes to the affected company's charter. Golden shares are held and used by governments to block transactions that are considered contrary to public policy.

[101] In a ruling on 13 May, the European Court of Justice (ECJ) said the British government's golden share in airport operator BAA, as well as the Spanish government's golden shares in Telefonica SA, Endesa SA, Argentaria and Tabacalera are in breach of EU law as they restrict the free movement of capital within the EU's single market. http://www.euractiv.com/Article?tcmuri=tcm:29-114116-16&type=News

[102] See for example Lander, M. "France cuts deal with EU to bail out Alstom", *International Herald Tribune*, May 26, 2004

tend to have higher margins and profits than domestic banks in developing countries, but that the opposite holds true in industrial countries.[103] The implication of these arguments and results indicate that cross-border bank M&As might create institutions that cannot compete successfully in the host markets (Buch and DeLong, 2001).

Because cross-border M&As generally contain the same elements of difficulty as domestic ones, though with differences in culture and language, it is widely perceived that cross-border deals are more complex compared to domestic transactions as no common framework within which to work exists. Berger et al. (2000) supports this understanding, although not providing statistical tests on the relative importance, that "efficiency" barriers such as distance as well as differences in language, culture, currency, and regulatory/supervisory structures are factors that inhibit EU cross-border deals in general and bank transactions in particular. In terms of language barriers Buch and Delong (2001) present though evidence that the importance of sharing the same tongue has fallen over the years as the difference between the percentages of deals where the partners shared a common language is significantly smaller in the 1990s than the 1980s.

8.4 Conclusion

The analysis of the ex-ante stage has highlighted four general motives, the strategic-, the market-, the economic, and the personal motive. It appeared that the former three motives are encouraging the financial industry to focus mainly on domestic consolidation. Synergies are more obvious and easier to exploit in domestic M&A's, the fragmentation of the financial industry in Europe lets firms to focus on domestic roll-up before turning abroad, and growing to a 'too big to fail' size that ensures government help needs to be achieved in the domestic market. In addition, it is often an interplay between various motives that result in M&As.

At the ex-post stage it became clear that integration is a major hurdle to M&As. One reason for the arising problems in integration could be found in the low resource allocation in the ex-ante and ex-post stage which causes ambiguity and confusion, resulting lacking strategic- and cultural fit between target and bidder. Simultaneously, management often turn their attention to other issues subsequent to signing the contracts, leaving the company alone when its comes to integration.

This in turn made me hypothesize that the ex-ante motives for M&A determine and require a specific strategy orientation and vice versa. Hence, the motives that seek efficiency enhancement,

[103] For a survey see Berger, A.N, DeYoung, R. Genay, H. and Udell, G.F. "Globalization of Finnacial Institutions: Evidence from Cross-Border Banking Performance", *Brookings-Wharton Papers on Financial Services* 3: 23-158, 2000.

i.e. strategic and economic, result in a strategy orientation with focus on centralization and integration, while the market motive requires the response and adaptation to local conditions.
As the domestic industry roll-up in banking was generally motivated to increase efficiency, they refrained from cross-border deals motivated by the market motive, not least because the immediate gains are less obvious and in addition would require larger investments in 'local responsiveness'. The few cross-border M&As in banking that actually occurred where motivated by efficiency seeking motives, implying a global strategy, which though was possible due to the similarities in corporate cultures and global orientation of these businesses.
Furthermore has the analysis revealed that there is generally no consensus on whether M&As create- or destroy value, thereby not specifically explaining the marginal cross-border deals. However, it was found that foreign banks generally do not seem to be as efficient in well-developed markets compared to domestic institutions, not encouraging an intra-EU expansion. In addition, other factors inhibit greater cross-border activity in Europe such as the widespread intervention of governments, as well as differences in language, culture.

9 Part 4 – Case Study

In this chapter I will use the insights gained from the previous parts and project them onto two recent cases of cross-border consolidation in Europe's financial industry, notably the creation of Nordic banking giant Nordea and HSBC's acquisition of Credit Commercial de France. The fact that substantial cross-border M&As have been so rare in Europe resulted in a very limited choice, particularly for examples that involve a considerable amount of retail banking operations, which though was not decisive.
The reason for choosing these two cases, although several other cross-border deals have been announced in recent time, notably the acquisition of Abbey National by Santander Bank of Spain, is because it takes up to three to five years after the acquisition until the acquired company has adjusted to the new situation (Walter, 1985). Also Levinson (1970), Marks (1982), Larsson (1990) and many other acquisition researchers believe that M&A is an open-ended, ongoing process that continues to affect an organization years and years after the legal acquisition actually takes place. Therefore, it would be to my understanding misleading to make a case study analysis on a transaction that has hardly been executed.
In the subsequent chapters I will present the two respective cases and review their developments prior, during, and after the merger.

9.1 Introduction – Nordea Case

In 1995, the merger between Union Bank of Finland and Kansallis had created Merita, a banking group that at that time was by far the dominant bank in the Finnish market. This merger caused that the product portfolio of Merita was strengthened significantly with strong life insurance products and mutual funds – with a 26 percent share, Merita obtained a leading position in the Finish mutual fund market with. Moreover, Merita had a strong expertise in corporate and international banking as well as a world-ranking PC banking system. The banks top management believed that its strong position in the wholesale market would make it necessary - despite being burdened by a huge volume of unsold properties from the Scandinavian banking crisis[104]- to grow and be more internationally oriented. Consequently, they cast a glance at Sweden in the fall of 1996, and started in April 1997 to hold merger talks with the Swedish government that was at that time the majority owner of Nordbanken.

Nordbanken was, after acquiring Gota Bank in 1993, an efficient middle-sized player in the Swedish market with a sharp retail focus, segmenting the market into 'low-value' accounts that were handled through 1,100 Swedish post offices, and higher-value accounts, which its own well-pruned branches concentrated on.[105] Having relatively few large corporate customers, Nordbanken had a very strong position in the small- to medium-sized enterprises (SME) area, as well as in the asset management and mortgage product market.

The negotiation between Merita and Nordbanken concerning strategic fit, synergies, valuation, and structural issues proceeded well and the merger was announced in October 1997. Its architects, Nordbankens CEO Hans Dalborg and Merita's CEO Vesa Vainio, saw the 'marriage' as a move that could strengthen 'Finanzplatz Norden' against competition from Brussels and Frankfurt and the large continental banks.[106] For Europe's financial landscape, the financial press, and academia the merger was extraordinary, "the SKr80bn ($10.6bn) merger [...] is noteworthy as one of the first cross-border deals between European retail banks," said the Economist.[107]

Forming a new Nordic super-bank with assets of almost $10bn, a customer base of 6.5 million individuals in Sweden and Finland, close to 300,000 SMEs and more than 400 full corporate customers, MeritaNordbanken ranked 20th in the European Banker's listing of the top 50 European

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[104] "Finally, the great Nordic super-bank", *European Banker*, October 1997
[105] Ibidem.
[106] Barnes, H. "Nordic banks get together", *The Banker*, December 1, 1997
[107] "Merger Monday", *The Economist*, October 18, 1997

banks by market capitalization - the largest Nordic bank, SE-Banken, at that time ranked 25th.[108]

9.1.1 Motives MeritaNordbanken

The purpose of combining forces between Merita and Nordbanken were amongst others to grow and obtain a wider customer base as well as preparing Nordbanken for the EMU by granting access to the 'Target'[109] transaction system of the European central banks, which would give it a competitive advantage compared to other Swedish players.[110] In addition, synergies of Skr970 million a year within three years, of which Skr630 million will be on the cost side as well as reducing the workforce by 600 employees to around 21,000 were to be achieved by merging forces.[111]

"We are proud of our achievement as an efficient retail bank [...] but we must create earnings growth for our shareholders, and we see more potential in (merging) than in staying on our own. This is our answer to the changes that are sweeping Nordic and European financial services", said Dalborg.[112] "Our mission was to create a strong Nordic entity that could compete against European heavyweights," recalls Arne Liljedahl, who was CFO of Nordbanken.[113]

Analysts remained though skeptical, acknowledging that there were clearly opportunities for cross-selling - notably Merita's life insurance products through Nordbanken's Swedish branch network, and the latter's asset management operations in Finland - but that in itself would not make the group a truly pan-European lending group. "People will be disappointed by this deal," said Peter Thorne, European banking analyst at Paribas in London. "It looks defensive and given the cultural difference between the two banks, it is not easy to see how it would be successful."[114]

The fact that the merger was across national boundaries has been subject to a good deal of critical comment on the grounds that the potential gains for shareholders look rather meager, as opportunities for rationalizing the branch network and slimming manpower, which are invariably the major attractions of mergers between domestic retail banks, were almost impossible to realize. "You don't save a lot of cost and you are not dealing with the same clients. The advantages are

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108 "Nordic banks lead way in European consolidation", *European Banker*, October 1997

109 The Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET) is the EU central banks' real-time euro gross payment system. It consists of 15 national real-time gross settlement systems and the European Central Bank's own payment mechanism, which are interlinked to provide a common platform for processing cross-border payments.

110 "Bigger is better (Isompi on Parempi)", *Kauppalehti*, October 15, 1997

111 "Nordic banks lead way in European consolidation", *European Banker*, October 1997

112 "Finally, the great Nordic super-bank", *European Banker*, October 1997

113 Larsen, P.F. "Border crossing", *CFO*, May 2004

114 Burt, T. "Merged bank aims for Nordic dominance", *Financial Times*, October 14, 1997

harder to see," says the Financial Times.[115] A Danish banker commented cynically: "The only ones to benefit from this merger will be Scandinavian Airlines and Finnair" - a snide reference to the amount of traveling between the two countries which executives will have to undertake. Consequently, the shares in Nordbanken, fell SKr4.50 to SKr274 in Stockholm, while Merita's most commonly traded A shares rose FM2.90 (34p) to FM28.10 in Helsinki. Analysts believed that Nordbanken share price reflected concerns that it could have achieved greater cost savings by merging with a domestic competitor, such as SEB.[116]

Mr Dalborg was though unfazed by these concerns, accepting that Nordbanken might have enjoyed greater cost benefits through domestic consolidation, which it actually considered earlier in 1997. Nevertheless, he maintains that MeritaNordbanken will be a happier union in the long run.[117] "If a cross-border banking merger is ever to succeed, this is the one," says Ian McEwen, banking analyst at Lehman Brothers in London. "It has able management committed to restructuring, strong technology and efficiency, plus a natural home market of culturally similar businesses and consumers."[118] Also, analysts from Salomon Brothers issued a highly positive analysis of the merger, suggesting that the gains from rationalization and improved business opportunities will be greater than the two banks themselves have estimated.[119]

The cause for this optimism was most probably Vainios indication that MeritaNordbanken had a broader Nordic strategy in mind: "We are inviting financial companies in the Nordic countries and Baltic region to participate in this growth", thereby making the first step towards creating a pan-Nordic banking giant.[120]

9.1.2 The 2nd and 3rd Merger

The first bank to answer MeritaNorbanken's invitation was Denmark's Unibank that has been able to establish itself in Poland, making it an ideal partner for MeritaNordbanken.[121] Though before considering a fusion with MeritaNordbanken, Unibank had to complete its merger with Tryg-Baltica, one of Denmark's leading insurance companies, that created Unidanmark.

Pertti Voutilainen, managing director of Finnish-based MeritaNordbanken was pleased about

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115 McIvor, G. "Pause for a breathing space after the frenzy", *Financial Times*, October27, 1998
116 Burt, T. "Merita plans Nordbanken merger", *Financial Times*, October 14, 1997
117 "Nordic banks expect happy union", *Financial Times*, November 12, 1997
118 McIvor, G. "Golden days for the big four", *Investors Chronicle*, March 13, 1998
119 Barnes, H. "Nordic banks get together", *The Banker*, December 1, 1997
120 Burt, T. "Merita plans Nordbanken merger", *Financial Times*, October 14, 1997
121 "Merita woos Unibank (Merita frier kraftigt til Unibank)", *Børsen*, May 20, 1999

Unibank's takeover of Tryg-Baltica making a merger between MeritaNordbanken and Unidanmark even more attractive.[122] "Over the years Unidanmark has had a sharply focused growth strategy in the Nordic area in order to boost its own competitiveness and to create long-term growth of dividends for its shareholders," said Joergen Hoeg Pedersen, chairman of the board for Unidanmark. "The merger [with MeritaNordbanken] is the next logical step in that direction," he added.[123] With the increased market capitalization subsequent to the merger with Tryg-Baltica, MeritaNordbanken and Unidanmark could now consider a 'merger of equals', valued at €4.78bn that was announced in March 2000 by representatives of both institutions. The newly formed bank, renaming itself Nordic Baltic Holding (NBH) had assets under management worth €186bn, a combined market capitalization of €15.6bn, and served a customer base, consisting of 8.5 million private customers, 450,000 SME's and 500 large business customers, from its 1,100 branch banks.[124] "MeritaNordbanken's strong position in the Swedish, Finnish and Baltic state markets and its leading position in Internet-based services, complement very well with Unidanmark's strong market position in Denmark and its specialties in wholesale banking and insurance and banking reinsurance", says Pedersen.[125]

Prior to its merger plans with Unidanmark, MeritaNordbanken attempted in October 1999 to expand to Norway by acquiring Christiania Bank og Kredittkasse, Norway's second largest banking group. This, however, turned out to be a more difficult and enduring endeavor than anyone could have imagined, as MeritaNordbanken met fierce nationalistic resistance from the Norwegian government, which was the majority owner for Christiania. Norway's Prime Minister, Kjell Magne Bondevik, argued at the height of the conflict to keep Christiania from being sold: "We need some big Norwegian banks because Norwegians know Norwegian conditions better than foreigners."[126]

MeritaNodbankens merger with Unidanmark was by many analyst believed to be an essential step to eventually win over the Norwegian government and get the approval of merging with Christiania.[127] As a consequence, after one year of negotiating and renewing the bid for Christiania several times, the Norwegian government accepted MeritaNordbankens NKr24.2bn bid in October

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[122] Ibidem.

[123] "Danish Unibank and Swedish-Finnish MeritaNordbanken merge", *Deutsche Presse Agentur*, March 8, 2000

[124] Ibidem.

[125] Ibidem.

[126] Crisscione, V. "Finance flies the flag", *Financial Times*, October 26, 2001

[127] Brown-Humes, C. and Maccarthy, C. "MeritaNordbanken in 4.8bn deal", *Financial Times*, March 7, 2000

2000, which led to the 'birth' of Nordea, the new name of the Nordic banking group.

9.1.3 Motives Nordea

MeritaNordbanken and Unidanmark cited the rapid structural changes that fundamentally altered the way financial institutions produce, market, and sell their products and services as the main reason for the merger. The growing importance of the Internet, mobile telephony, and electronic trading required both investment and a large volume of transactions, they said. A marked increase in competition in the Nordic market following the Single Market Act, adoption of the euro, as well as the general liberalization of credit and capital markets added to these considerations.[128]
Subsequent to NBH's successful bid for Christiania, Mr Dalborg said that through the transfer of best practices, cross-selling of products, and the sharing of IT and administration costs, the group will be able to offer its clients a broader range of services at competitive costs. He added: "We will focus on customer benefits from sharing Nordic ideas and the realization of synergies".[129]
Nevertheless, this strategy appeared not convincing for everyone, again due to the rather obscure cost synergies that these transactions yielded compared to domestic ones. In addition, combining four banks under a decentralized management by merging, rather than a straightforward takeover, made it difficult to push through cost-cutting measures.[130] To quote Mr Straarup, Danske Bank's CEO: "I don't believe that the establishment of so-called equal partnerships is a short-cut to attaining economies of scale or, for that sake, economies of scope."[131] Also Børsen, the leading Danish business newspaper, seemed to agree noting that: "Nordea could face difficulties merging the four banks due to domestic differences in financial regulations."[132]
Nevertheless, the reception of the transactions was largely positive. Moody's Investors Service announced for example to review for possible upgrade of the long-term deposit and debt ratings of the merged group, as well as the financial strength ratings of Nordbanken AB (A1/C+), Merita Bank Plc (A1/C) and Unibank A/S (A1/C). The Aa3 rating for mortgage bonds issued by Unikredit Realkreditaktieselskab, a subsidiary of Unibank, has also been placed on review for possible upgrade.[133]

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[128] "Danish Unibank and Swedish-Finnish MeritaNordbanken merge", *Deutsche Presse Agentur*, March 8, 2000
[129] George, N. "Nordic banking and finance, cross-border ambitions start to be realized", *Financial Times*, October 31, 2000
[130] Ibidem.
[131] Ibidem
[132] "Nordea seeks common Nordic legislation (Nordisk storbank presser politikere for fælles tilsyn), *Børsen*, June 7, 2001
[133] "MeritaNordbanken and Unidanmark to merge", *Nordic Business Report*, March 7, 2000

9.1.4 Post Merger Developments and Integration - Nordea

After the merger between Merita and Nordbanken, it was decided to locate the merged bank's legal home in Finland to avoid the Swedish system of double taxation of dividends, which would have caused Merita's shareholders to sell out en masse. MeritaNordbanken's executive headquarters on the other hand were located in Stockholm, where Nordbankens CEO Hans Dalborg will be chairman of the 11-person executive board, which is divided 50-50 between Swedish and Finnish members.[134] While section 8.1 showed that tax and accounting considerations are not main reasons for an M&A transaction, Steger and Kummer (2004) nevertheless note that they play a role when a deal is executed and decisions about the design and structure of the transaction need to be taken in order to optimize tax burdens. Especially for 'merger of equals', which Merita and Nordbanken was, a dual-headed group structure, i.e. a 'multi-headquartered' company, is often favorable in order to exploit the country specific advantages and to satisfy shareholders from both nations.[135]

Outlining what else needs to be done to integrate the two entities, Dalborg quotes Mao: "It will be the tyranny of many small steps", starting by reviewing the profitability of its three main profit centers - retail banking, corporate banking, and real estate. In retail banking, Merita will have the opportunity to roll out Nordbanken's successful specialized financial packages across its branches, while Merita's well-established life insurance operations can be distributed through Nordbanken's branch network. On the corporate side, Mr Dalborg wants to build up the underdeveloped stock-broking and corporate finance activities as "in these areas [the bank] is not good enough to be one among many, you have to have a unique competence."[136] Customers will though hardly notice any difference as besides assigning the banks a common name and logo, there will be otherwise no major changes and both entities will continue to operate independently of each other in their respective markets.[137]

Boosted by the general economic upturn in the global economy and the stock markets as well as the smooth integration, MeritaNordbanken shares performed rather well, which made it possible

[134] The personable Dalborg will have to exercise all his man-management skills to ensure that the work of his board does not deteriorate into trench warfare between Finns and Swedes, whose languages and cultures - including business cultures - are very different, and spiced by a Finnish inferiority complex vis-a-vis a richer and more powerful people who ruled Finland for several hundred years.

[135] Steger, U. and Kummer, C. "M&A activity in the new competitive milieu', in "Managing complex mergers" edited by Morosini P. and Steger U. *Prentice Hall Financial Times*, 2004

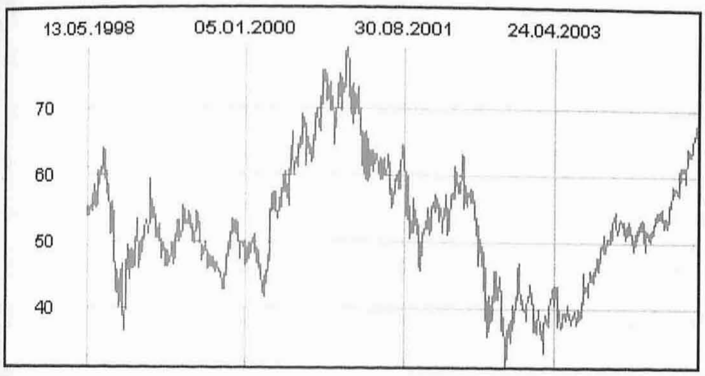
[136] "Nordic banks expect happy union", *Financial Times*, November 12, 1997

[137] Barnes, H. "Nordic banks get together", *The Banker*, December 1, 1997

for the group to attempt to realize its Nordic strategy by making a take-over proposal for Christiania less than two years after merging Merita and Nordbanken.

By merging with Unidanmark, Nordea turned in less than three years into a major player, far larger than any of its Nordic counterparts, having close to 10 million private and 1 million corporate customers, 1,240 branches and a market share of 20 percent in Sweden, 40 percent in Finland, 25 percent in Denmark, and 10 percent in Norway.[138] Though with share prices peaking at SKr79 in January 2001, as Figure 19 indicates, just a month after the merger with Christiania, the share performance started to tumble to a low of SKr31.5 in October 2002 before recovering to its recent (December 2004) level of SKr65.[139]

Figure 19: Nordea's share performance



Source: http://www.nordea.com

The disappointing performance can partly be blamed on the way financial markets have developed at that time, where Nordea had to grapple with falling stock markets, subdued economies, and the lowest interest rates for more than a generation[140], contrasting the rosy times when Nordbanken and Merita joined forces in 1997. The second two deals were consummated in 2000, just as the markets were beginning to weaken. "We had to grab the opportunities while they were there", argued Mr Dalborg, knowing that adding two banks in such a short time interval, when markets were unfavorable, added hugely to the difficulty of integrating them.[141]

Not surprisingly then did Nordea fail to deliver on the revenue synergies it had promised, "We found we couldn't afford to integrate at the speed we had hoped for, because we didn't have the

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[138] George, N. "Cross-border complexities", *Financial Times*, August 25, 2003
[139] George, N. and Maccarthy, C. "Bank investors take account of contrasts", *Financial Times*, August 20, 2002
[140] Brown-Humes, C. "One brand too many cultures", *Financial Times*, April 23, 2004
[141] Ibidem.

necessary income because of the weak market," says Mr Nordstrom.[142] To that comes, that only days after Nordea reported a 44 percent drop in first-half profits in 2002 by struggling to keep costs under control, Thorleif Krarup, who took over the position as CEO from Mr Dalberg, stepped down from his position. He was leaving his post "due to the negative impact of my CEO assignment on my personal situation and the strains on my CEO obligations due to that situation".[143] Being in a severe crisis, analysts accordingly speculated that the merger had lost its momentum and that reforms became mired in the cultures of four former nationally-focused banks.[144]

Luckily, Mr Krarups CEO successor, Mr Nordstrom, felt it was time to get a grip. "We were perceived to be over-promising and under-delivering," he says in an oblique reference to the massive €720m of savings that Mr Krarup had promised.[145] "We have too many of everything - too many branches, too many people, too many banks, too many mangers, too many solutions, too many products, too many IT systems. The only things we don't have too many of is customers."[146] Mr Nordstrom's strong focus on cost-cutting helped Nordea's share price to recover significantly in 2003, not least by means of scaling back its investment banking ambitions, divesting non-core businesses such as insurance, and generally prioritizing profitability instead of product range. With one of the highest cost-income ratios in Nordic banking, hovering around 63 percent, the original goal was to reach a 50 percent cost-income ratio, though due to the various problems Nordea faced, a more modest target 55 percent was to be achieved by 2005.[147]

The problems Nordea faced were not just a matter of legislation, currency, and language but of mindset, which has led to a far too complicated structure. Most comparable European banking deals involved a bank with a strong home market position buying a smaller bank in a neighboring market. But there was no dominant bank in Nordea's case, which meant that at the outset of integration process was more consensual than it should have been. "Our mindset was directed towards integration, towards negotiation, towards being too polite to each other. Instead of people stepping up and saying: now it's decision time, this is the way we are going to do it", says Mr Nordstrom.

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[142] Ibidem.
[143] George, N. and Maccarthy, C. "Nordea chief replaced after profits slump", *Financial Times*, August 27, 2002
[144] George, N. "Nordea chief aims to restore faded luster", *Financial Times*, September 4, 2002
[145] Brown-Humes, C. "One brand too many cultures", *Financial Times*, April 23, 2004
[146] George, N. "Cross-border complexities", *Financial Times*, August 25, 2003
[147] George, N. "Nordea reduces banking ambition", *Financial Times*, November 19, 2002

Inevitably, different teams in different banks fought for their own solutions. Nowhere was this more apparent than in IT. In mid-2002 Mr. Nordstrom wanted to consolidate the entire bank's IT in one site. Eight months later, he found that nothing had been done. The solution was to outsource the operation, which is why an IT joint venture was formed with IBM late in 2003.[148] "The mistake we have made is to try and handle complexity instead of trying to eliminate it. Complexity is a cost driver."[149]

Critics argue that the poor performance of Nordea just underlines the difficulties of cross- border integration as Nordea generally performed worse than Nordic peers such as Svenska Handelsbanken and Den Danske Bank in measures such as share price performance, return on equity, and cost-to-income ratio. In addition, it admits that it is still some way from being one bank.[150] While Mr Nordstrom says "It's somewhere in between but closer to one," others disagree, saying there "are still four different banks. It's only when you get to the very top of the organization that you appreciate there's an umbrella over the whole thing".[151]

Nevertheless, everybody acknowledges, "the management challenge facing Nordeas management was huge. They have been trying to do something that has not really been done in banking before, at least in developed markets […]. Retail banking is a local business, whereas investment banking is a global one," says Rohit Ghose, banking analyst at Citibank in London.[152] Citibank's Mr Ghose claims that these problems with integration were triggered because: "Nordea is a hot-potch collection of banks, many of which were never best of breed in their home markets."[153]

Though Mr Dalborg disagrees strongly, saying that the bank has not been without its successes. Its scale has for example enabled it to become a much greater force in corporate banking than would otherwise have been the case.[154] In addition, he insists still being "very enthusiastic" about the merger, saying that "the idea is absolutely right; the execution could have been firmer. But we have started to be firmer and more decisive."[155]

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148 Brown-Humes, C. "One brand too many cultures", *Financial Times*, April 23, 2004
149 George, N. "Cross-border complexities", Financial Times, August 25, 2003
150 Brown-Humes, C. "One brand too many cultures", *Financial Times*, April 23, 2004
151 Ibidem.
152 Ibidem.
153 Ibidem.
154 Ibidem.
155 Ibidem.

9.2 Introduction HSBC – CCF Case

Having introduced the Nordea case, I will now review the acquisition of Credit Commercial de France (CCF) by the Hong Kong Shanghai Banking Corporation Limited (HSBC) in 2000. HSBC is a multinational banking group that was established in 1865 with the main objective to finance the growing trade between China and Europe. Due to its continuous growth that was both organic and through various acquisitions, HSBC became one of the worlds largest banking and financial services organizations, employing 146,000 people worldwide with a market capitalization of $118bn and total assets worth $569bn (in 2000).[156]

Just prior to its acquisition of UK's Midland Bank in 1992, HSBC relocated its headquarters to London, realizing that the European market and in particular London was vital for it future development.[157] Generally, the 1990s were HSBC's most dramatic growth period, with several acquisitions causing its product portfolio to grow rapidly. Its core activities fell into four main sectors: financial services, commercial banking, corporate investment banking, and markets and private banking - in 2001, 98% of profits were derived from these activities.[158] As regards the geographical representation, the HSBC Group is a truly global player, with 9,500 offices in 79 countries and territories, and assets distributed evenly between Europe, Asia, and the Americas.[159]

CCF on the other hand was formed in 1917 after Banque Suisse et Francaise merged with Maison Aynard et Fils (of Lyon) and Caisse de Crédit de Nice.[160] From that moment, the bank has expanded steadily both through organic growth and by acquisitions, ranking in 1969 as the world's twelfth most active bank in the international financial markets. Under the provisions of the law of February 11, 1982 the bank was nationalized through the transfer of its shares to the French state. Under state ownership, CCF achieved a leading position in France with regards to home banking and euro-franc bond issues. State ownership did though not last long and in 1987 CCF was re-privatized.

At the time of HSBC's takeover in 2000, the CCF Group employed 13,430 people, had a market

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156 In 2003 the group's assets reached $ 983bn and it employed 218,000 people, "HSBC Group Fact Sheet", August 2003, available at http://www.hsbc.com.

157 "Group History" available at www.hsbc.com

158 A closer look into the company's portfolio reveals that corporate investment banking and markets accounted for 38% of business in 2001 and generated pre-tax profits of $4,030 million. Private banking activities contributed 4% of group profits, while commercial banking profits accounted for 23% of the group total. Finally, personal financial services' contribution equaled 33% of HSBC business.

159 Green, S. Hassan, F. Immelt, J. Marks, M. and Meiland, D. "In Search for Global Leaders", *Harvard Business Review*, August 2003.

160 The information on CCF is based on the information available on the CCF's official website, http://www.ccf.com.

capitalization of €9.1bn and consolidated assets of €69.3bn. The main focus of CCF was on retail banking and distribution, corporate and investment banking, and asset management, and its retail clientele was mainly "mid-to-upper" range with over 500,000 personal customers and high-quality business customers as well as some 50,000 corporate customers. To that came CCF's regional banking subsidiaries that it acquired previously and are operating under their own brand name. These regional subsidiaries add a further 550,000 personal customers, 76,000 corporate customers, some 37,000 professional and small business customers and more than 19,000 associations and institutional customers to CCF's client group.

9.2.1 Motives HSBC - CCF

The major motives for HSBC's acquisition of CCF was to develop its wealth management business – private banking and asset management[161]- as well as entering the French retail banking market[162] with CCF's 650 branches and more than one million customers including major French companies.[163] By entering the French market, HSBC would moreover expand its presence in the euro area, where the bank had been underrepresented. As Sir John Bond said, the deal was "a unique opportunity to acquire a well-managed, fast-growing French bank […] and to establish a significant base for operation in the euro zone".[164]

CCF on the other hand was motivated to become part of HSBC due to the growth prospects in its own domestic market that this deal would allow. As Charles de Croisset, the Chairman of the CCF Group, put it, "the conditions of globalizing markets made it necessary for CCF to join a leading banking group in order to accelerate its growth and development"[165], thereby being progressive in the demands for improved services and products. Becoming a part of the HSBC group, allowed CCF to broaden its product and service offerings by drawing on HSBC's leading international position and its recognised expertise in certain fields such as cash management. Apart from the willingness to grow and develop, CCF was also motivated by the simple drive to achieve financial stability. This need has resulted from the fact that all French banks suffered from profitability problems in the beginning of the 1990s.[166]

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161 "Global Balancing Act", *Private Banker International*, April 14, 2000.
162 "HSBC feels boost from CCF deal", *Financial News*, February 26, 2001.
163 Johnson, A., "HSBC pays GBP 6.6BN in French Bank Takeover", *The Express*, April 3, 2000.
164 "Global Balancing Act", *Private Banker International*, April 14, 2000.
165 The official web site of CCF: http://www.ccf.com.
166 The recession of the early 1990s led to an increase in risks and a substantial rise in costs associated with them, following a huge increase in demand for credit. The high rate of business failures in France became a real challenge for credit institutions. This effect

What was remarkable about the deal was that HSBC, which is a bank that prides itself on acquiring targets on the cheap, has paid - at three-and-a-half times book value - top euro for CCF, even though it has made so many concessions to the French bank, such as keeping the CCF brand name, refraining from layoffs, and leaving CCF's headquarters in Paris.[167] These requirements were set, not so much by CCF itself, but by its most influential stakeholders, namely the French government and the financial regulators, that were very reluctant to let a French bank being acquired by a foreign corporation.

Nevertheless, "the agreement is the result of in-depth discussions between the two groups, which took place on a totally friendly basis and led to a clear and concerted plan for CCF. The offer is an excellent one for our shareholders", says de Croisset.[168]

The overall strategic fit between the two entities was very promising giving HSBC its first sizable foothold in the euro zone - which HSBC' CEO thinks is a must: "You cannot be a credible player in the euro zone if you don't have a significant on-the-ground presence".[169]

From a product line perspective, CCF was able to bring some "welcome expertise" into HSBC's own fund-management operations and adding some of CCF's fund-managed products that had appeal in the UK.[170] Moreover, CCF's focus on an affluent clientele, neatly dovetails with Bond's strategy of building up HSBC's asset-management portfolio. "CCF is a very good-quality bank whose businesses are an excellent fit with HSBC", says also banking analyst at Salomon Smith Barney, John Leonard.[171]

9.2.2 Post Merger Development and Integration – HSBC

With the French government being the main shareholder, it was essential for HSBC to make various concessions and guarantee that the decision centres remained in France in order to get the permission from the French authorities. Because HSBC was itself founded and developed as a locally present but centrally coordinated bank, the plan was to keep CCF as an autonomous unit, but with certain structural changes to rationalize, gain synergies, and avoid overlaps.

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was strengthened by turmoil on foreign exchange and interest rate markets in the same period and resulted in stagnant net banking income. In fact, in the worst year of 1994, the net banking income for all credit institutions fell by more than 7 percent. Finally, between 1994 and 1998 the profitability of French banks has increased significantly, which helped to increase banks' capital and make France's banking system more solvent. Although the French banking sector seemed to be recovering at a fast pace, the memory of recent profitability problems might give birth to the willingness to avoid similar troubles in future.

167 "HSBC treads Softly", *The Economist*, April 8, 2000.

168 Ibidem.

169 Capell, K. Stanley, R., "The Long Reach of HSBC", *Business Week*, April 17, 2000

170 Johnson, A. "HSBC pays GBP 6.6BN in French Bank Takeover", *The Express*, April 3, 2000.

171 Capell, K. Stanley, R., "The Long Reach of HSBC", *Business Week*, April 17, 2000

Consequently, while CCF would maintain its French management team headquartered in Paris, all of HSBC subsidiaries present in France, which though were not many, were integrated with CCF and controlled by it as it was closer to their specific business area.

Because no major parts of CCF's operations were to be integrated into HSBC's structure, the cultural and organizational fit between the two corporations was in this case not an essential factor, as CCF was virtually left autonomous. A good illustration of CCF's autonomy and 'special' status was its exemption from HSBC's policy of common branding under the HSBC name. CCF was allowed to remain its initial name and branding strategy, just the logo and the same letter-style was changed to the hexagon symbol of HSBC.

CCF excellent performance record before the merger caused HSBC's management to hold on to the already established structure. Due to a large degree of complementary in CCF's and HSBC's operations, in itself limiting the needs for rationalizing jobs, caused that there were only marginal job losses. Completing its integration into HSBC in only four months, also the legal integration of CCF into the HSBC structure appeared to run without greater difficulties and opposition, much due to the thorough preparations and strategic planning of the two parties, and an excellent cooperation between the two parties. Thus, the authorities and financial regulators approved the terms quickly, and the trade unions showed no signs of agitation in the weeks following the deal's announcement.[172]

Nevertheless, integration would most probably not run as smooth, if CCF would not be performing as good as it did. In 2000, CCF was the most profitable French bank, and in fact one of the most profitable European banks, with an annual return on equity over the past 13 years of 19 percent compared to average returns for French banks of about 14 percent.[173] Simultaneously this meant that cost-cutting was limited; only one third of the €150 million of the promised synergies could be derived from cost cutting.[174]

CCF's employees and shareholders were satisfied hearing that HSBC paid a large premium for their bank's assets, while HSBC's shareholders reacted with more concern. Consequently, the shares of HSBC fell nearly 4 percent on news of its € 11bn bid for CCF.[175] This reflected shareholders' worries that the bank was paying a too high price in its friendly acquisition with a

172 Iskander, S. "French Put Different Gloss On Friendly Takeover", *The Banker*, Vol. 150, No. 891, May 1. 2000

173 Capell, K. Stanley, R., "The Long Reach of HSBC", *Business Week*, April 17, 2000

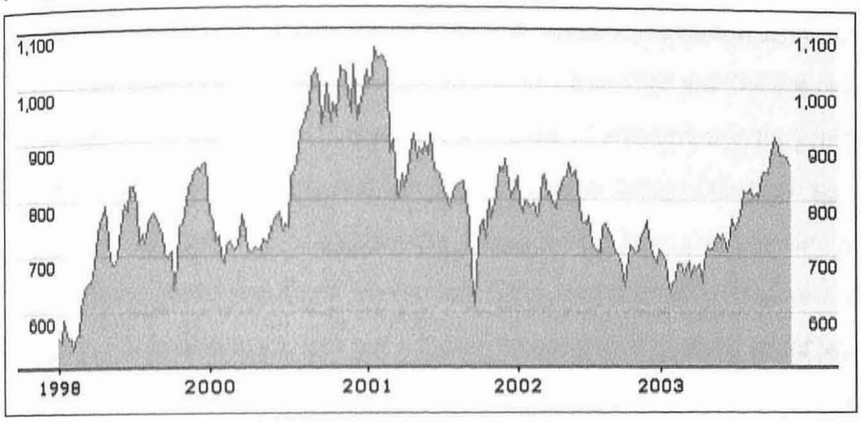
174 "HSBC treads Softly", *The Economist*, April 8, 2000

175 "HSBC dives on CCF deal", *Hong Kong Standard* (China), April 04, 2000.

price-to-book valuation 3.5 times acquisition price.[176]

Though HSBC's share price soon recovered and did not seem to be affected greatly by the initial dissatisfaction of HSBC shareholders, experiencing, as Figure 20 illustrates, a significant share price increase till the end of 2000. It is nevertheless important to note that both the growth towards the end of 2000 and the decrease of prices subsequently were very much consistent with the general market trends.

Figure 20: Weekly share prices for HSBC, listed on London Stock Exchange in the period of 1998-2003 [GBP].



Source: Reuters Finance. Available at http://www.reuters.com

In contrast to shareholders, the international rating agency Fitch assigned a positive outlook to the AA-long-term debt rating of HSBC, reflecting the bank's recent acquisition of the CCF. HSBC's already internationally diverse global banking franchise had been, according to Fitch, significantly strengthened.[177] Moreover, HSBC's profitability will benefit from a more diverse revenue stream, both in terms of markets and products, which will help reduce income volatility and maintain core operating earnings. Also, Samer Iskander[178] was positive about the HSBC – CCF deal, terming it "a textbook example of how to avoid the pitfalls that threaten cross-border transactions in general and banking takeovers in particular".

As HSBC's CEO puts the CCF deal: "It [CCF] will also significantly increase our wealth management basis, one of the key objectives of our strategic plan, and expand our ability to meet the needs of our global corporate and institutional clients".[179]

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[176] Ibidem.
[177] "Acquisitions boost HSBC credit rating", *Hong Kong iMail* (China), Sep 19, 2000.
[178] Iskander, S. "Foreign Banks Exploit Gap In French Defence - As The Race To Acquire French Banking Interests Intensifies, Consolidation Is The Only Escape Route", *The Banker*, Vol. 150, No. 892, June 1, 2000
[179] Ibidem.

9.3 Analysis of the Cases

Having introduced the two cases and outlined the major developments prior, during, and subsequent to the respective transactions, I will now proceed with analyzing them in depth to evaluate the applicability of my findings from the previous sections.

9.3.1 Financial Regulation & Supervision

Integrated financial regulation and supervision in which banking, securities, and insurance regulation and supervision is combined within a single agency was first tried in Scandinavia almost two decades ago. Norway was the first country to establish an integrated financial sector supervisory agency in 1986, followed by Denmark in 1988 and Sweden in 1991. According to Taylor and Fleming (1999)[180] there are a number of similarities in the general outline of their systems. The scope, powers, and governance arrangements of the three agencies bear a strong family resemblance. The Scandinavian agencies each have a broadly similar regulatory scope. They regulate bank, non-bank investment firms, and insurance companies, mainly to ascertain their solvency. Finland though, has not adopted an integrated financial sector supervisory agency due to the difficulty of combining its unique systems of compulsory pensions and other social insurance with market-based financial supervision (Taylor and Fleming, (1999)). Hence, Finland's Financial Supervision Agency regulates only banks and securities firms, with insurance companies and compulsory private sector pension schemes regulated by the Insurance Supervisory Agency. Despite the widespread similarities in the financial supervisory structure of the Nordic countries, Nordea's cross-border merger caused difficulty as the institutions from four countries were involved in the decision making and approval, all of them having slightly different approaches and represent different national interests e.g. in respect to job losses and supremacy. Nevertheless, the Nordea case caused the cross-country cooperation to improve between the Scandinavian regulators and supervisory institutions. This was underlined in autumn 2000 when the four Nordic countries concluded on a Memorandum of Understanding covering supervisory matters, which calls for increased information sharing and co-operation regarding planning and executing on-site inspections.[181]

The HSBC-CCF case was in this respect more straightforward as it only involved regulatory and

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[180] Taylor, M. and Fleming A. "Integrated Financial Supervision – Lessons of Scandinavian Experience", *Finance and Development*, 1999

[181] "Supervision of Financial Services in the OECD Area", *OECD Publication*, p. 28 www.oecd.org/dataoecd/29/27/1939320.pdf & guest lecture by Finanstilsynet

supervisory bodies from two countries. Nevertheless, these two countries, France and the UK, are in this respect very different from the Scandinavian countries. The UK adopted in 1997 a single financial services regulator, the Financial Services Authority (FSA), which, according to Gardener and Molyneux (2002)[182] is a reflection of the ongoing universalisation of the UK banking industry in Europe's most important and sophisticated financial market. In addition, the Bank of England transferred in June 1998 its responsibilities for prudential supervision of banks to the Financial Services Authority (FSA).[183] As a result, the UK has with the FSA one single body that is in charge of regulation and supervision of financial institutions.

In France, however, regulation and supervision was at that time more complicated as it did not have an integrated financial regulatory body. Hence, several agencies and regulators had responsibility for regulatory investigation and enforcement in the financial services sectors with their jurisdictions overlapping from time to time. Generally, there was the Commission des Opérations de Bourse (COB)[184], the Conseil des Marchés Financiers (CMF)[185] and the Commission Bancaire (CB)[186]. For banks and investment firms, prudential supervision is performed by the CB, licensing by the Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI) and regulation by the Comité de la Réglementation Bancaire et Financière (CRBF) and the CMF. The COB had sole responsibility for authorized investment firms providing essentially management services. For insurance firms, the main supervisory agency was the Commission de Contrôle des Assurances (CCA), while the Ministry of Finance was responsible for licensing and regulations.

Financial institutions were subject to ongoing supervision by Banque de France inspectors, acting on behalf of the CB, which is in charge of credit institutions supervision in France.[187] Besides the rather complicated structure of financial regulation and supervision at the time of HSBC's acquisition of CCF[188], HSBC had to expect and cope with significant government intervention, as

[182] Gardener, E.P.M., and Molyneux, P. "United Kingdom", to be found in "Banking in the New Europe", Gardener, E. P.M. Molyneux, P. and Moore, B. *Palgrave Macmillan, London/Basingstoke*, 2002

[183] Cervellati, E. M. "Financial regulation and supervision in EU countries", University of Bologna, 2002, www.efmaefm.org/AcceptedPapers2003/ CervellatiEnricoMaria/CervellatiEnricoMaria.pdf

[184] Securities and Exchange Commission

[185] Financial Market Council

[186] Banking Commission

[187] Plihon, D. "France", to be found in "Banking in the New Europe", Gardener, E. P.M. Molyneux, P. and Moore, B. *Palgrave Macmillan, London/Basingstoke*, 2002

[188] The French Minister of Economy and Industry announced on 11 July 2002 that he intended to set up a single regulatory body. This project will be included in the draft loi de sécurité financière (Financial Security Act) to be introduced before parliament in September. The merger should simplify the regulatory supervision of markets and investment services providers.

it 'dared' to make a take-over attempt of a French bank, resulting in the before-mentioned concessions from HSBC's side.[189]

Hence, when comparing the institutional set-up of the two cases, it appears that although the Nordea case involved regulatory and supervisory institutions from four countries, the rather similar structure of relying on one institution that is in charge of both regulatory and supervisory activities for all financial institutions, Finland's insurance industry being an exception, reduced the hurdles significantly. HSBC on the contrary, who also has a centralized institution dealing with regulation and supervision at home, had to cope with the complicated and fragmented French structure of financial regulation and supervision, while complicating matters even further through direct government intervention.

9.3.2 Motives

While there is no doubt that HSBC made an outright acquisition of CCF, the transactions in the Nordea case are slightly less obvious. The deal between Nordbanken and Merita was announced as a 'merger of equals' because both entities were similar in size. The subsequent transactions with Unidanmark and Christiania would, due to MeritaNordbankens and then NBH' size dominance indicate that they were acquisitions, however, they were termed 'merger of equals' due to political reasons related to obtaining shareholder acceptance. Subsequent to Krarups departure as CEO of Nordea one former Nordea manager noted: "The merger died with Thorleif Krarup. Instead of collegial co-operation, it became a Swedish takeover."[190]

9.3.2.1 Strategic Motives

Strategic motives played certainly a role for both HSBC and Nordea to justify the transaction although anticipated synergies were, as mentioned earlier, of less substantial value than in case of domestic consolidation and therefore not the prime motive. Nevertheless, the static synergy effects through savings and rationalization were estimated for both Nordea and HSBC to lay between € 100-150 million spread over several years. More synergy potential was though to be in the dynamic synergy effects through the transfer of knowledge and expertise from its new entities. While HSBC gained wealth management expertise from CCF, Nordea's benefited from Merita

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[189] For more on financial regulation in France and the UK see for example "The financial services sector in Europe - Regulatory investigation and enforcement issues in France", *Freshfields Bruckhaus Deringer*, 2002 (www.freshfields.com/practice/fig/publications/pdfs/3928.pdf) and Cervellati, E.M. "Financial regulation and supervision in EU countries", University of Bologna, 2002, www.efmaefm.org/AcceptedPapers2003/CervellatiEnricoMaria/CervellatiEnricoMaria.pdf

[190] George, N. "Nordea chief aims to restore faded luster", *Financial Times*, September 4, 2002

sophisticated internet-banking system, which helped the other three entities to gain a substantial foothold in the internet banking market in Scandinavia that led to cost savings in the longer run. Also the asset management expertise of Nordbanken, and the insurance products from Unidanmark, resemble dynamic synergies that the group benefited from. However, one should be aware that expressing synergies in numerical values is often very complicated and biased by e.g. management that needs shareholder approval, which is why synergy announcements should generally read with care. Another indicator that questions the validity of synergy estimations is the high failure rate of M&As when it comes to the delivery of synergies in the form of cost-savings. Becoming a large player in Europe's financial market that would put it in a position to withstand the ongoing changes in the EU and the increasing competition in the banking landscape was the underlying strategic motive of Nordea. Similarly, HSBC's motivation to enlarge its presence in the important EU market where it at that time was underrepresented can also be termed a strategic motive, though it is interrelated with the market-seeking incentive, discussed next.

9.3.2.2 Market Motives

Besides improving its wealth management expertise, HSBC was seeking for an opportunity to expand to EU markets where it felt underrepresented. Hence, the combination of acquiring, although not at a bargain price, one of Frances' top-ten banks, that in addition had a track record of being one of the most efficient banks in Europe, with a well-developed wealth management arm, and a large retail banking network, seemed a great opportunity to achieve that.

The underlying motive of Nordea was not so much concerned with expanding its presence in other markets, though due to the relatively small size of the Nordic countries in terms of population, it was inevitable to expand to neighboring countries to realize the goal of achieving a respectable size. Hence, the market motive seems to be interrelated with the strategic motives of becoming a 'banking giant', as one caused the other. Consequently, it appears that for both cases the strategic motives were dependent, in one way or another, on the market motives, and vice versa.

9.3.2.3 Economic Motives

Despite the divergence on the existence of scale and scope economies in the financial industry, these arguments were certainly used in both cross-border transactions.[191] In particular the

[191] See for example the presentations at press conferences and meetings with analysts available at http://www.nordea.com/sitemod/upload/Root/www.nordea.com%20-%20uk/Investorrelations/2000_unidanmark.pdf and http://www.nordea.com/sitemod/upload/Root/www.nordea.com%20-%20uk/Investorrelations/2001_TK_

possibilities for cross-selling each others products, e.g. life insurance, mutual funds, and investment banking expertise, it is repeatedly mentioned as an opportunity to increase revenues and decrease costs. In addition, by combining and transferring expertise, potential advantages in terms of product development, information search, and raising capital were anticipated.

While being interrelated with the strategic reasoning, creating a Nordic banking giant was certainly also an economic motive that would help the group to withstand the competitive pressures that advancements in technology, the EMU, and changes in regulation initiated. In addition, achieving the size of a 'banking giant' is also relates to the 'too big to fail' incentive, which though is not communicated officially, as is the political influence that follows size.

In both cases though the economies of scale and scope arguments were used rather carefully, and were usually 'wrapped' in the synergy argument.

9.3.2.4 Personal Motives

Whether personal motives of top management are at least partially involved for one of the above transactions is obviously speculation. Nevertheless, creating a Nordic 'super size' bank and being involved in the first-ever cross-border merger between banks from four different countries, undoubtedly was prestigious, and could indicate that it was a great chance for e.g. Dalborg and Vainio to make history by building an 'empire'. In addition, the complexity of such a merger could have furthermore motivated the involved decision-makers as they could prove their abilities that this, despite widespread doubts, can be done.

Also the fact that de Croisset obtained an executive position in HSBC subsequent to the acquisition of CCF could indicate that personal motives were present in this transaction as becoming an executive director in HSBC most probably had significant impacts on his personal wealth.

Nevertheless, as the presence of personal motives is difficult to prove, it should though never be disregarded from M&A incentives. In both of the above cases the weight of this motive was though not central as the transactions could be justified by means of the other, value-creating motives.

To sum-up, it appeared that strategic motives coupled with economic incentives led to the creation of Nordea. The small market and restrictions on monopolistic market structures made it simply impossible for either one of the respective banks to a gain a competitive size at home, leaving cross-border M&As as the only way forward.[192] HSBC on the other hand was primarily motivated market motives to expand its branch network and strategic motives to extract synergies.

9.3.2.5 Motives and Corporate Strategy

In accordance with the before proposed 'motive-strategy grid', presented in section 8.2.1, Nordea's motives called for a global strategy orientation as the focus was on efficiency improvements. With the specific characteristics of retail banking one would initially anticipate that this is a foolish approach as it is conflicting with the notion that particularly retail banking requires local responsiveness to succeed, and that incompatible corporate structures and cultural peculiarities would prevent integration. Nevertheless, the global strategy approach became feasible because the Nordic countries are very similar, "we share the same history, the same cultural background, the same Lutheran value system," said Dalborg.[193] An issue that complicated the pursuit of the chosen global strategy significantly was the fact that the four merged entities were pursuing a very consensus-driven 'merger of equals', hampering its ability to drive through changes and deliver on various cost-cutting synergies. "It was a necessary choice at first, but later there were a number of problems related to always having to watch the balance of power between the banks", notes Vaara.[194]

As a result of choosing a strategy that did not seem to suit the type of transaction, aiming for efficiency on the one hand, and responding to and dealing with unanticipated national differences and resentment on the other hand, caused the performance of the group to deteriorate (see section 9.3.3.1).

However, with a Swede to replace Danish Krarup as CEO, many senior managers saw the Swedish contingent becoming the dominating force in key parts of the company (Vaara, (2003)), thereby transforming the 'merger of equals' to more of a Swedish takeover, starting the second wave of integration.[195] Nordstroms focus was to move away from the decentralized structures of four different banks under one name[196] and to instead integrate and centralize activities and processes, making Nordea converge to one bank. Hence, after some delay, caused by internal ambiguity,

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192 Larsen, P. F. "Border crossing", *CFO*, May 2004
193 Brown-Humes, C. "One brand too many cultures", *Financial Times*, April 23, 2004
194 Larsen, P.F. "Border crossing", *CFO*, May 2004
195 Ibidem.
196 An example of Nordea's decentralized infrastructure was its patchwork of IT systems inherited not only from the four banks, but also from a slew of national mergers that preceded Nordea. As Merrill Lynch's analysts note "Even today, the group still uses five separate IT data centers, 60 separate back-office processing centers, 13 call centers, 2,200 IT applications on 13 server platforms and four country-specific product sets." (Larsen, P.F. "Border crossing", *CFO*, May 2004)

Nordea eventually pursued its 'proposed' strategy orientation, and starts to deliver on the announced integration promises, although slowly.

In comparison to Nordea, the integration of CCF into HSBCs corporate structure was fast and did not cause any significant problems. An explanation for a company's success in integration subsequent to acquisitions is according to Lubatkin (1983) a firms acquisition expertise and experience. HSBC's long history of acquiring banks in many countries ranging from Asia, over Europe, to the Americas caused that HSBC was very familiar with the banking industry in general and learned form its M&As in foreign countries. Therefore it was aware that it does not know markets where it did not operate before, which explains that HSBC kept CCF's management.

A study by Very, Calori, and Lubatkin (1993) of French-British acquisitions revealed that, in addition to corporate cultural differences, there are also national cultural differences that can affect the financial outcome of an acquisition. Hence, managers need to take the fundamental differences into consideration to understand the acquired company and to deal with potential conflicts. HSBC seemed to have done that as it was aware that it "should pay particularly close attention to issues of cultural compatibility, and try to establish when possible leadership styles, rules of conduct, and administrative procedures […] that are consistent with the national values of the employees at the acquired organization" (Very, Calori, and Lubatkin, 1993).

Knowing that it would not be very simple to acquire a French bank - ING was a case in point[197] - HSBC gave many concessions to the French authorities and CCF in order to achieve its goal. Hence, this strongly suggests that the strategy HSBC pursued when acquiring and integrating CCF was in accordance with its slogan 'think global, act local', putting a great deal of emphasis on local

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[197] HSBC's takeover attempt of CCF was not the first time that CCF was in the situation of being a target in an acquisition. In fact only some four months earlier, on Friday December 10th, the largest Dutch Bank ING has made an attempt to takeover CCF with a bid that was valued €10bn, some 15 percent more than CCF's market value. Though, by the time Europe's markets reopened on Monday December 13th, ING had already withdrawn its bid, as CCF was unenthusiastic about the deal. There has been a great deal of speculation why ING withdrew its offer so soon and the Economist termed ING's attempt ironically "the shortest takeover battle in history".

As the two banks already co-operated in a number of areas and ING even had a seat on CCF's board, it came very surprising to ING that CCF showed them the cold shoulder. ING claims that the two banks had been discussing a tie-up for several months, and seemed a good fit: ING's global expertise in insurance and investment banking would complement CCF's strength in French asset-management and corporate banking. Besides, ING even refrained from lay-offs and offered attractive position to CCF's bosses in order to please French sensitivities. CCF, as the Economist reports, presents though a different story. It characterized ING's bid as rushed and short on detail while also being displeased by the 48-hour deadline that ING had attached for a recommendation of its offer. As a result, CCF may have simply been holding out for a higher price, given the rarity value of a French bank on the block. But there may be other explanations for its snub. When ING's bosses met Jean-Claude Trichet, governor of France's central bank, he is said to have expressed reservations about what would be the first foreign takeover of a French bank. The Banker reports, that even though EU law states that neither the French government nor financial regulators are allowed to block a bid for a French company on the grounds that the bidder is foreign, both institutions warned clearly that they would find ways to stop foreign banks from entering the French market. As a result of ING's failed attempt, CCF remained in play as an acquisition taget, as few could imagine that it is big enough to survive without a partner in a unifying Europe. And indeed, only some four months after ING's attempt, HSBC put forward an offer to takeover CCF, even though there were no previous relations between these two companies.

responsiveness and autonomy as this was necessary to succeed. Whether HSBC followed a multinational- or a transnational strategy orientation is not entirely clear, though it seems reasonable to conclude that it is more on the transnational side than on the multinational side as the deal had a positive impact on HSBC's overall performance, not least through the synergies.
The outcome of brief analysis and applicability of the 'motive-strategy grid' on the two cases appeared to speak in favor of this conceptualization. In the case of Nordea the grid showed correctly that Nordea's motives for its transaction were requiring a global strategy to take effect. In the case of HSBC, the grid also indicated that HSBC's motives called for a strategy that responded to the local peculiarities, and as such resulted in a rapid and smooth integration. As the verification of the 'motive-strategy grid' is based on the selected examples, one should interpret these results with care as it is not representative.

9.3.3 Performance of Transactions

An initial idea of the performance of the two transaction gives a panel of 13 experts[198] that was put together by The Banker to evaluate which of the M&As in 2000 involving the financial sector would lead to a happy marriage and which will end in acrimony and possibly divorce.[199] As depicted in Table 4, the domestic Barclays/Woolwich deal received the most positive outlook, though followed by MeritaNordbankens merger with Unidanmark, and its subsequent deal with Christiania. The panelists liked the strong logic to both Nordic deals and they had nothing but admiration for CEO Dalborg's acquisitive run against the background of regional banking consolidation.
HSBC's acquisition of CCF, resulted in a 7th place, and although the deal has been understood as a solid transaction by an experienced cross-border acquirer that gave it a 'toehold' in continental Europe, it failed to ignite the panel's imagination. Professor Roy Smith from the Stern School of Business says: "No foreign company has yet managed to turn around a former state-owned French

[198] Steven Davis, Davis International Banking Consultants; Claire Gouzouli, a director at First Consulting; Raphael Soifer, consultant, Soifer Consulting; Bryan Crossley, banking analyst, ABN Amro; Philip Middleton, European financial strategy partner, KPMG; Professor Roy Smith, New York University's Leonard N. Stern School of Business; Professor David Rogers, New York University's Leonard N. Stern School of Business; Bert Ely, consultant, Ely & Company; Richard Coleman, bank analyst, ABN Amro; Martin Green, bank analyst, Merrill Lynch; Vasco Mareno and Garth Leder, bank analysts, Fox Pitt Kelton; Professor Ingo Walter, New York University's Leonard N. Stern School of Business; Angus Hislop, financial services partner, PricewaterhouseCoopers Merger rankings

[199] Piggott, C. "Will They Be Happy?" *The Banker*, Vol. 150, No. 898, December 1, 2000.
The survey was done by asking these experts a total of more than 1000 questions to analyze the strengths and weaknesses of deals and the experts were asked to give marks out of five for both the likely benefits (a list of five items) and potential pitfalls (six items). By working out a bank's average positive and negative scores across the categories and summing the results the study arrived at a table of mergers with the highest-rated at the top and lowest-rated at the bottom.

company, but if they did it, then it would be seen as a bold move".[200]

Table 4: Expert evaluation of cross-border M&A's in the financial sector, in 2000

Overall Ranking	Overall Score	Companies
1	1.44	Barclays/Woolwich
2	1.28	MeritaNordbanken/Unidanmark
3	1.21	MeritaNordbanken/Christiania
4	1.15	RBS/NatWest
5	0.86	Firstar/US Bancorp
6	0.65	Danske Bank/RealDanmark
7	0.20	HSBC/CCF
8	0.13	Chase/Robert Fleming
9	0.03	Salomon/Schroder
10	-0.13	HypoVereinsbank/Bank Austria
11	-0.27	UBS/PaineWebber
12	-0.39	Chase/JP Morgan
13	-0.45	CSFB/DLJ
14	-1.20	Dresdner/Wasserstein Perella

Source: Piggott, C., "Will They Be Happy?", The Banker, Vol. 150, No. 898, December 1, 2000.

These experts expected that HSBC would run into problems when integrating CCF, however, which the above review though showed was not the case.

This preliminary evaluation of the two transactions, leads me now to review and evaluate their respective financial performance subsequent to the deals. As mentioned already, the integration in both cases might not be final yet, which is why the outcome in terms of financial performance might not be final yet, meaning that improvements or deteriorations can still occur and shed a completely different light on the outcome. This likelihood however, is rather small as several years have already passed.

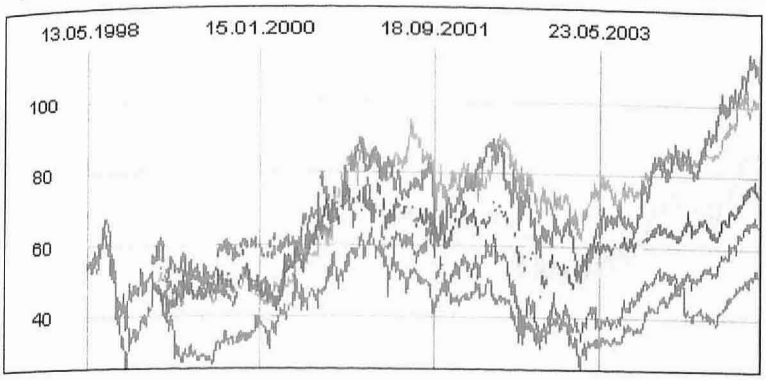
9.3.3.1 Nordea

When looking at Nordea's share price performance over the previous five years, as illustrated in Figure 21, it appears that almost simultaneously to its final merger with Christiania in October 2000, its shares started a constant downturn, tumbling to its absolute low of SEK 31.5 in March 2003. Despite the general downturn in the stock market, its Nordic peers, particularly Den Norske Bank and Danske Bank, but also SHB and SEB, all performed better. Only Swedish FSPA (not on

[200] Piggott, C. "Will They Be Happy?" *The Banker*, Vol. 150, No. 898, December 1, 2000.

the chart) and Finnish Sampo had a similar mediocre performance as Nordea.

Figure 21: Nordea's share performance compared to Nordic peers (13.05.98 - 24.01.05)



Source: http://www.nordea.com
Note: From upper right-hand side: Den Norske Bank (red), Danske Bank (green), SEB (silver), SHB (dark red), Nordea (blue), Sampo (grey)

After reaching its absolute low in March 2003, Nordea's share gained strength, as did the general market. In particular though saw Den Danske Bank and Den Norske Bank, but also SEB and SHB, significant improvements in their share performance. Nordea however could not follow suit. Also, most Nordic stock market indices, except for the Swedish SX40-Financials, outperformed Nordea's shares. It therefore seems that shareholders and the market were rather disappointed by the mergers and the realized synergies and cost reductions, indicating that it did not succeed in creating shareholder value.

From an accounting based approach, illustrated in Table 5, it appears that the operating profit declined from €2,4bn in 2000 to €1,5bn in 2002, a decline of almost €1bn, which though partly resembles the economic downturn and the costs of consolidating Nordea's operations.

Table 5: Selected accounting based figures of Nordea's financial performance

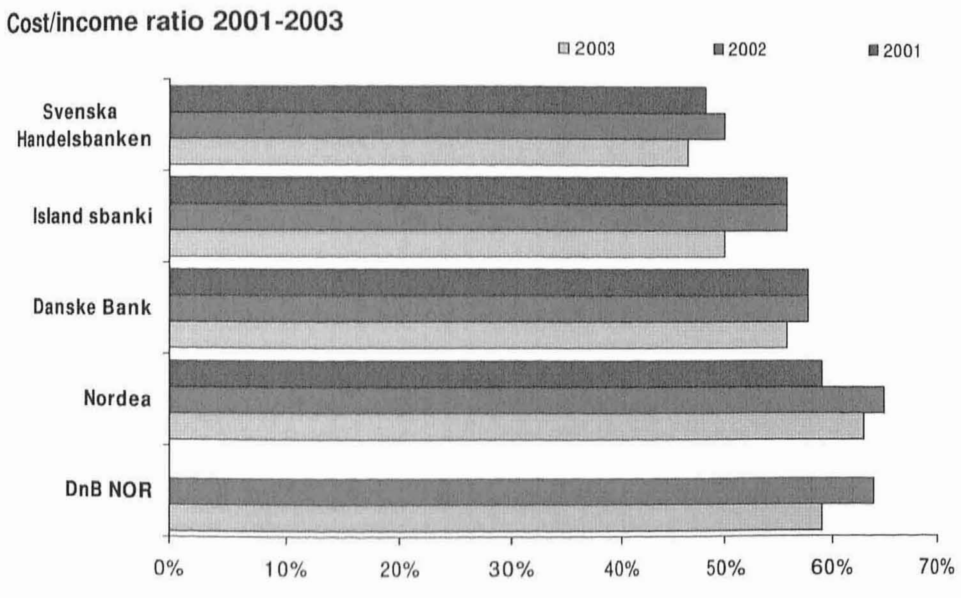
	1999	2000	2001	2002	2003
Operating Profit in € mln.	2,089	2,437	1,901	1,547	1,812
Deposits in € bn	65	79	83	94	96
Lending in € bn	104	129	138	146	146
Total assets in € bn	186	224	242	261	262
Return on equity (RoE)	18	16.1	13.8	7.5	12.3
Cost to income ratio	59	55	58	64	63
Earnings per share in €	0.55	0.58	0.53	0.3	0.51

Source: Nordea's Annual Reports 2000-2003

The results for 2003 showed therefore improvements with the operating profit to increase to €1,8bn, which indicates that Nordstrom's cost cutting measures in Nordea were finally making an impact on its balance sheets. In addition, Nordea could report a 15 percent increase in operating profit to €1,648 million from January to September 2004 compared to 2003 figures, furthermore illustrating that performance improvements are taking effect.

Nordea's ambition to gain size through the four-way merger was though undoubtedly realized with both deposits, lending, and total assets increasing markedly between 1999 and 2003. Nevertheless, the cost-to-income ratio of 63 percent in 2003 compared with 47 percent at SHB and just under 55 percent at Danske Bank, gave reason for concern. In an interview in the CFO[201], Liljedahl, CFO of Nordea, argues that the market's focus on this is "somewhat unfair". The cost-to-income ratio "doesn't reflect the efficiency of a bank," he says. Nordea's business mix, where retail banking makes up some 70 percent of turnover, means it is bound to have higher costs than peers that aren't as heavily involved in retail. Nevertheless, Liljeahl reckons that "Our cost-to-income ratio is just north of 60 percent, but it should be possible to come closer to 55percent".

Figure 22: Nordic comparison of cost-to-income ratio, 2001-2003



Source: Annual Report Islandsbanki 2003

Figure 22 displays the development of the cost-to-income ratios of several Nordic banks, and it shows that Nordea remains to have the highest percentage. Nevertheless, the first three quarters of 2004 saw slight improvements with respectively 59, 63, and 61 percent.[202]

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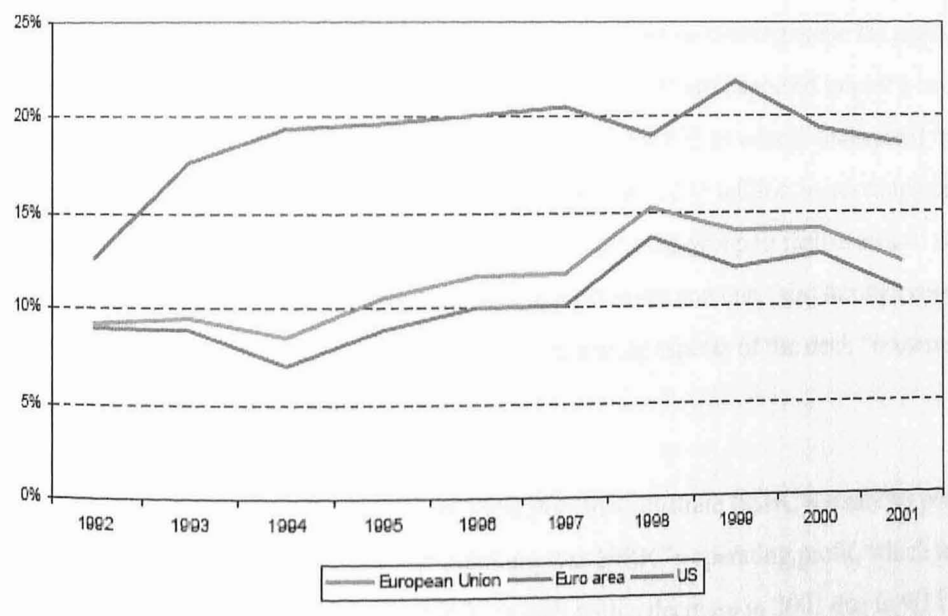
201 Larsen, P.F. "Border crossing", *CFO*, May 2004

202 "Presentation for investors", Nordea, October 27, 2004 available at: http://www.nordea.com/sitemod/upload/root/eu/interim/Investor_presentation_Q304.pdf

Similarly, Nordea's return on equity (RoE) went through a phase of deterioration subsequent to the merger, declining from 16.1 percent in 2000 to only 7.5 percent in 2002. Following Nordstroms appointment the RoE recovered in 2003 by increasing to 12.3 percent. When comparing Nordea's RoE to Figure 23, illustrating RoE's from banks in the EU and the US, one notices that Nordea's 2001 performance with 13.8 percent is pretty much in line with other banks from the European Union. Nevertheless, its poor 7.5 percent in 2002 most certainly would have been far below European average. It is though striking from this figure that US banks are on average performing much better than European banks, with an RoE's on average 5 percent higher than Europe's. Because both the market based approach and the accounting-based approach indicate a rather mediocre performance of Nordea, which though is improving now, it seems that the creation of Nordea by consolidating across the Nordic region took more time than expected. The unknown complexity of a multi-cross-border merger combined with the unfavorable economic conditions influenced the delay in the realization of promised synergies. Nevertheless, with the appointment of Nordstrom as CEO and the subsequent clarity about the (global) strategy orientation, substantial improvements in the financial performance started to shine through.

Figure 23: Return on equity of banks



Source: OECD, Bank profitability (2002 ed.); Date of publication (last data available): Apr. 03 (2001)

A recent edition of the FT[203] agrees saying that "promised synergies have taken longer to materialize than expected. However, the bank sprang a surprise with its second-quarter [2003] results, with evidence that some of the synergy benefits were starting to come through."

9.3.3.2 HSBC

Evaluating HSBC's post acquisition performance by looking at its share price performance reveals that over the past five years it was outperforming the FTSE 100 significantly (Appendix I). Particularly between the middle of 2000 till the first few months of 2001 a significant increase in HSBC's share performance occurred. Despite the fact that it coincides with the acquisition of CCF, it is unlikely that this increase can solely be traced back to this event, not least because also the other large UK banks saw a similar pattern in their share performance. Nevertheless, it appears that HSBC was the third best performing UK bank behind RBS and Barclays. HBOS', Lloyds' and Abbey's performance on the other were particularly since the middle of 2002 deteriorating constantly, not keeping up with the three top-performing banks. And although the acquisition of CCF was relatively small in comparison to HSBC's 'almighty' size, impacting HSBC share performance only marginal, it is nevertheless reasonable to assume that from a share performance perspective, the deal was a success, despite of HSBC's initial shareholder reaction.
Looking at HSBC's post-acquisition performance from an accounting angle the acquisition of CCF would yield an initial economic value of €95 million. CCF was expected to post a net profit of €650 million in 2001, to which €150 million of synergies will be added. Subtracted from this are €420 million of financial charges from the operation and €285 million representing the cost of new capital issued, leaving €95 million. John Bond expected the group to realize around two-thirds of a projected total €150 million of synergies through revenues and one-third through cost savings. As he said, HSBC was emphasizing the revenue- enhancing aspects of the deal, "because we intend to grow the business, not to shrink it".[204]

Table 6 summarizes several accounting indicators that illustrate HSBC's financial performance in the period 1999-2003. Particularly astonishing was HSBC's operating profit, which increased significantly to more than $12bn in 2003, though with a decrease in 2001 due to 9/11 and the economic downturn. In addition, both HSBC's deposits, lending, and total assets increased

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[203] Brown-Humes, C. "Banks running out of options: Nordic Cross-Border Links: But seeking growth beyond their home markets brings its own problems" *Financial Times*, October 8, 2003
[204] "Global Balancing Act", *Private Banker International*, April 14, 2000

considerably over this period. One of the reasons for this growth was HSBC's acquisition of CCF and the accompanied assets and large customer base. Nevertheless, HSBC's various other acquisitions of banks in this period, notably its $14.3bn acquisition of Household Bank of the US, contributed greatly to his development.

Table 6: Selected financial data on HSBC Group in the period 1999-2003.

	1999	2000	2001	2002	2003
Operating Profit in US mln.	7,409	9,477	7,153	9,035	12,297
Deposits in US bn	354	416	413	448	493
Lending in US bn	398	487	504	548	579
Total assets in US bn	570	674	696	759	1,034
Return on equity (RoE)	18.1	16.8	13.3	12.6	13.8
Cost to income ratio	53.2	55.4	56.9	57.4	51.3

Source: HSBC Holdings plc. Annual Report and Accounts 1999-2003. Available at http://www.hsbc.com

HSBC's acquisition frenzy affected though its profitability, with its RoE decreasing from 18.1 percent in 1999 to 12.6 percent in 2002. The RoE recovery to 13.8 percent in 2003 is compared to its UK peers still the lowest, with RoE's from Barclays, HBOS, and Lloyds reaching 17.5, 17.9 and 27.3 percent respectively.[205] Nevertheless, the first half of 2004 saw a further recovery of HSBC's RoE increase to 16.3 percent, indicating that the banks profitability is improving.
In respect to its cost-to-income ratio was HSBC's performance though rather good; in fact its 2003 achievement of 51.3 percent was the second lowest amongst its UK peers just topped by HBOS.
After this brief review of HSBC share- and accounting performance subsequent to its acquisition of CCF, it appears that the outcome can by no means be regarded as a failure. Furthermore, it is important to know that HSBC acquired several other banks in the period 2000-2003, influencing its balance sheet both positively in terms of growth and negatively in terms of profitability.
Because CCF was in comparison to HSBC rather small, the direct effects of CCF's integration are not reflected as pronounced and obvious on HSBC's balance sheet and performance indicators. On the other hand, HSBC's performance also did not deteriorate to an extent that would indicate that integration of France's most profitable banks failed. Hence I agree with The Banker, that writes in its May 1, 2002 issue, "It is reasonable to cite HSBC's acquisition of France's CCF [...] as successes."

[205] Long. R. and Hughes, D. "UK bank comparison study", *Dominion Bond Rating Service*, December 2004 available at http://www.dbrs.com/web/sentry?COMP=2900&DocId=146591

9.4 Summary of Case Study

The two cases studies have illustrated several interesting points that underline the previous findings. The differences in the institutional set-up in terms of financial regulation and supervision were highlighted, with the UK and the Nordic countries having one main body, compared to France's complex and fragmented structure. Furthermore, it appeared that several motives, which often seem interrelated, are present in M&As. Nevertheless, the analysis of the motives generally reveal two broad categories for engaging in these M&As, the efficiency seeking motive of Nordea versus the market seeking motive of HSBC – with the personal motives resembling a special case not investigated further here.

Another finding from the case studies was that integration is potentially 'make or break' for the success or failure of the transactions. On the one hand was the complex 'merger of equals' in Nordea's case, that was very consensus-driven but not delivering on promises. About to collapse, the new CEO Nordstrom changed Nordea's integration approach by means of a global strategy orientation, which was in line with the 'motive-strategy grid', and started to deliver on the announced promises by substantial performance improvements. On the other hand was the HSBC-CCF case that was simpler in terms of involved parties, two instead of four, but more complex in terms of national and institutional differences. Its expertise and strategy choice, the market-seeking motive suggested, according to the 'motive-strategy grid', a strategy that 'prescribed' a flexible and decentralized approach, let HSBC integrate CCF rapidly and smoothly into its organizational structure.

Consequently, the two cases are supporting Morosini's (2004) finding that fast, assertive, and clear approaches to M&A integration end up being more beneficial than consensual approaches focusing on balancing the joining companies' stakes equally at every possible level.[206]

10 Conclusion

Significant measures have been undertaken to create a level playing field that would encourage the integration of Europe's financial markets and thereby result in widespread cross-border M&As in the Europe's banking industry. And while Europe can be considered as one of the most integrated banking market worldwide from a legal perspective (Buch and Heinrich (2002)), the systematic

[206] Morosini, P. "Are mergers and acquisitions about creating value?", in "Managing complex mergers" edited by Morosini P. and Steger U. *Prentice Hall Financial Times*, 2004

analysis of four key segments of Europe's financial market has revealed that there appear to be large differences in the progress of integration. Whereas the money market appears almost perfectly integrated, the retail market remains very fragmented.

Inhibiting to further integration, and thereby to wider cross-border M&A activity, is the slow materialization of directives caused particularly by diverging national interests and a lacking unified supervisory structure. Furthermore, the different legal, administrative, accounting, tax, and consumer protection systems will need to be dismantled to achieve the objective of an integrated European financial market.

The unprecedented M&A activity in the 1990s across all industries underlines this as it was predominantly of domestic nature, with the financial services industry, and banking in particular, being no exception. Nevertheless, the recent trend of gradual increasing cross-border activity, seems to indicate that the 'integration measures', such as the SBD, CAD, and not least the EMU are starting to take effect, causing particularly financial institutions from smaller EU Member states to look beyond it national boundaries for growth opportunities. Yet, the frequency of such intra-EU deals is still marginal, especially in the larger EU countries, indicating that domestic consolidation is hitherto not completed to a degree that lets firms seek for expansion targets outside their domestic market. The 'ultimate' test of an integrated European financial market therefore seems to have failed.

The analysis of the micro perspective furthermore revealed that the strategic-, the market-, and the economic motives for M&As are encouraging the banking industry to focus mainly on domestic consolidation. Synergies are more obvious and easier to exploit in domestic M&A's, the fragmentation of Europe's financial industry lets firms to exploit first domestic opportunities before turning abroad, and attempting to grow to a 'too big to fail' size needs to be achieved in the domestic market. The micro-level analysis additionally showed that the ex-post M&A integration resembles a major hurdle to realize the anticipated benefits of M&As. The doubly complexity of cross-border transactions with differences in language and culture combined with evidence that foreign banks generally do not seem to be as efficient compared to domestic institutions, (which though does not mean that cross-border M&As are performing worse than domestic deals) adds to this and deters cross-border activity further.

This in turn made me hypothesize that the motives for M&As require specific strategies to deliver on the transactions, which I conceptualized in the 'motive-strategy grid' that is based on the Integration-Responsiveness grid. Hence, motives that seek efficiency enhancement require a strategy orientation with focus on centralization and integration, while the market motive requires firms to respond and adapt to local conditions.

The two cases of Nordea and HSBC revealed that, besides illustrating the differences in the institutional set-up in terms of financial regulation, supervision, and government intervention, the proposed 'motive-strategy grid' appears valid. Nordea's expansion on the one hand was driven by efficiency-seeking motives, calling for a global strategy orientation. The ambiguity and poor performance in the first years that were caused by the consensus-driven 'merger of equals' approach, was followed by considerable improvements in performance when Nordstrom got appointed as CEO, and focused stringently on the global strategy orientation. The strategy orientation that the 'motive-strategy grid' suggested in HSBC's acquisition of CCF also proved successful. When acquiring a target where large differences in national and organizational culture can be expected, it requires the bidder to be flexible and pursue a decentralized approach to integration granting autonomy to the new entity. Though to verify the applicability of the grid further research is needed.

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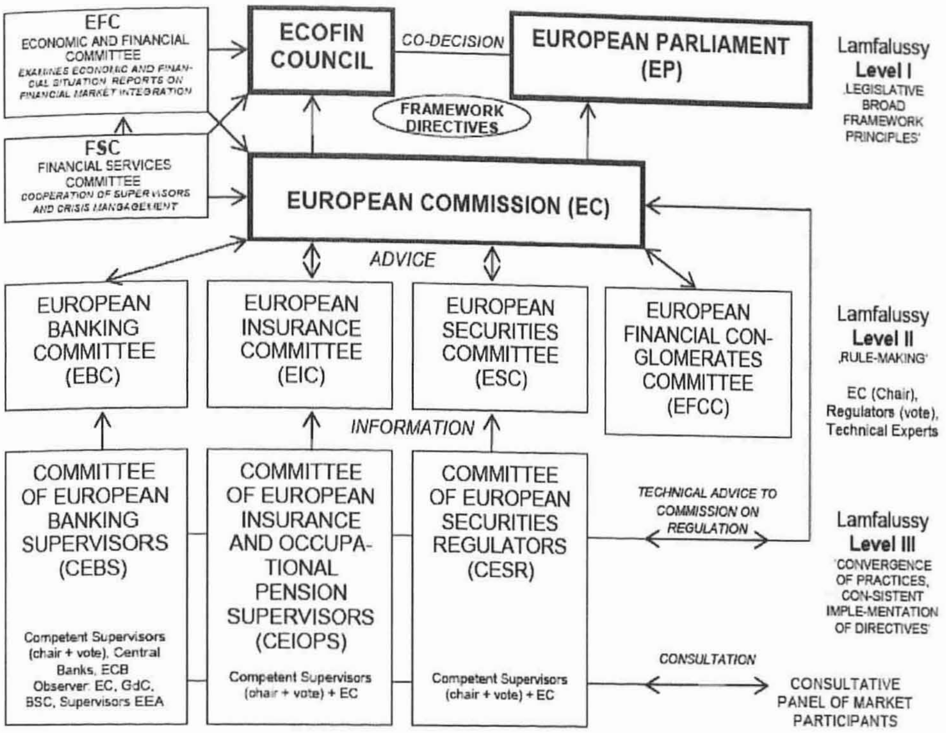
12 Appendix

Appendix A: Overview of individual measures in the Financial Services Action Plan

Strategic objective 1: a single EU wholesale market
Upgrade the two Directives on Prospectuses.
Update and upgrade the Regular Reporting Requirements.
Directive on Insider Dealing and Market Manipulation (market abuse).
Communication on and Directive to upgrade the Investment Services Directive (ISD).
Communication on Conduct of Business Rules in the ISD (distinction between professional and retail investors).
Amend the 4th and 7th Company Law Directives to allow fair value accounting.
Communication updating of the EU accounting strategy followed by legislative action.
Modernisation of the accounting provisions of the 4th and 7th Company Law Directives.
Recommendation on EU auditing practices (quality assurance and auditor independence).
Implementation of Settlement Finality Directive.
Directive on financial collateral arrangements.
Adoption of the proposed Directive on Take Over Bids.
Political agreement on the European Company Statute.
Review of EU corporate governance practices.
Amend the 10th Company Law Directive.
14th Company Law Directive.
Commission Communication on Funded Pension Schemes.
Adoption of the two Directives on UCITS.
Directive on the Prudential Supervision of Supplementary Pension Funds.
Strategic objective 2: open and secure retail markets
Political agreement on proposal for a Directive on the Distance Marketing of Financial Services.
Commission Communication on clear and comprehensive information for purchasers.
Recommendation to support best practice in respect of information provision (mortgage credit).
Commission report on differences between national arrangements relating to consumer-business transactions.
Interpretative Communication on the freedom to provide services and the general good in insurance.
Proposal for amendment of Insurance Intermediaries Directive.
Commission Communication on a single market for payments.
Commission Action Plan to prevent fraud and counterfeiting in payment systems issue.
Commission Communication on an e-commerce policy for financial services.
Strategic objective 3 : state-of-the-art prudential rules and supervision
Adopt the proposed Directive on the Reorganisation and Winding-up of Insurance Undertakings.
Adopt the proposed Directive on the Winding-up and Liquidation of Banks.
Adopt the proposal for an Electronic Money Directive.
Amendment to the Money Laundering Directive.
Commission Recommendation on disclosure of financial instruments.
Amend the Directives Governing the Capital Framework for Banks and Investment Firms (Basel 2).
Amend the solvency margin requirements in the Insurance Directives.
Amendment of the Insurance Directives and the ISD to permit information exchange with third countries.
Adopt a Directive on Prudential Rules for Financial Conglomerates.
Commission Decision for a Securities Committee and a Committee of Securities Regulators.
General objective: wider conditions for an optimal single financial market
Adopt a Directive for ensuring taxation of interest income from cross-border investment of savings.
Implementation of the December 1997 Code of Conduct on business taxation.
Review of taxation of financial service products.

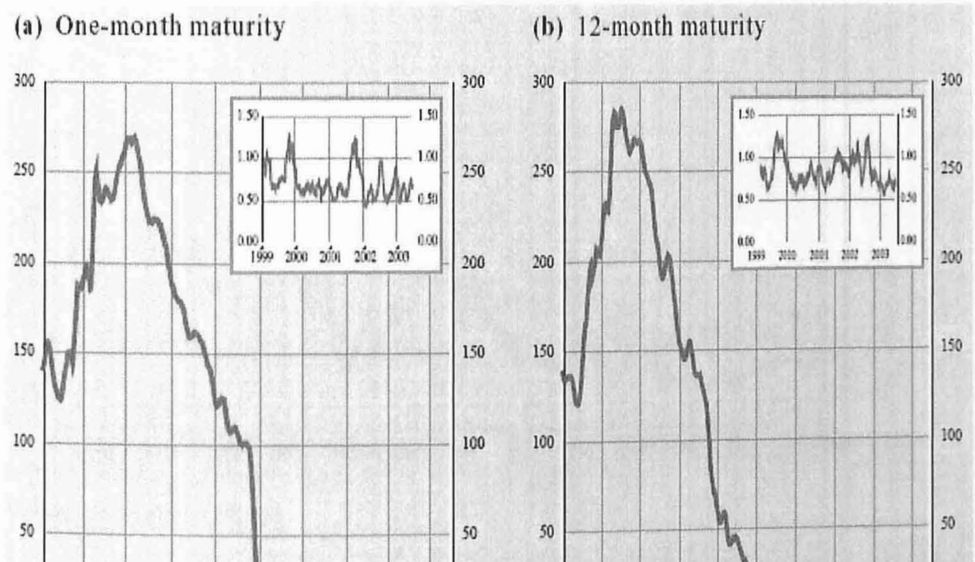
Source: Progress Report (2001) and OECD. Available at
http://europa.eu.int/comm/internal_market/en/finances/actionplan/

Appendix B: Illustration of the 'Lamfalussy model'



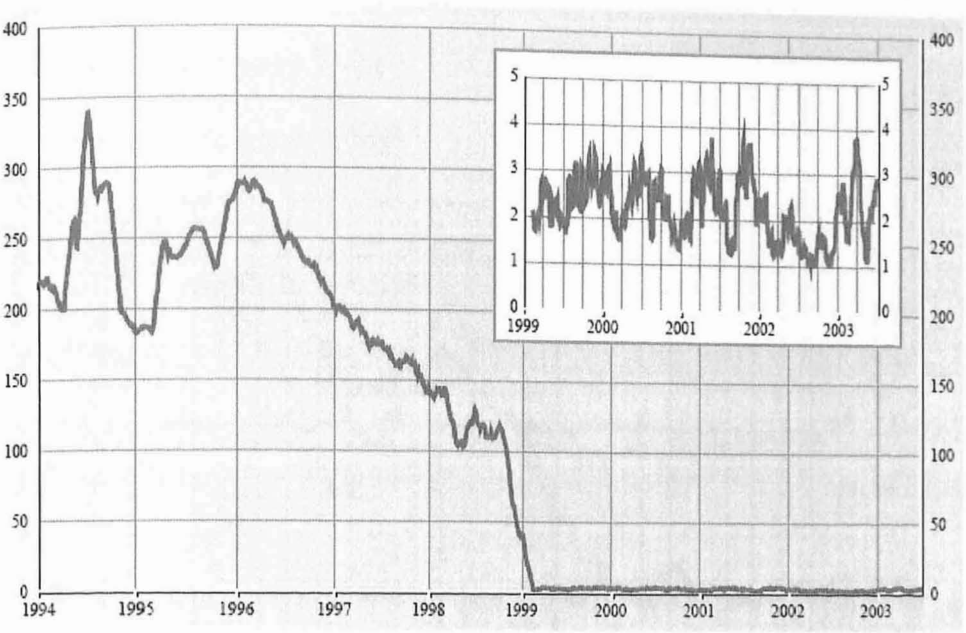
Source: "Regulation and Supervision of Financial Institutions and Markets - A European Perspective", available at http://www.wwz.unibas.ch/cofi/efma/papers/103.pdf

Appendix C: Cross-sectional standard deviation of unsecured lending rates among euro area (30-day moving average, basis points)



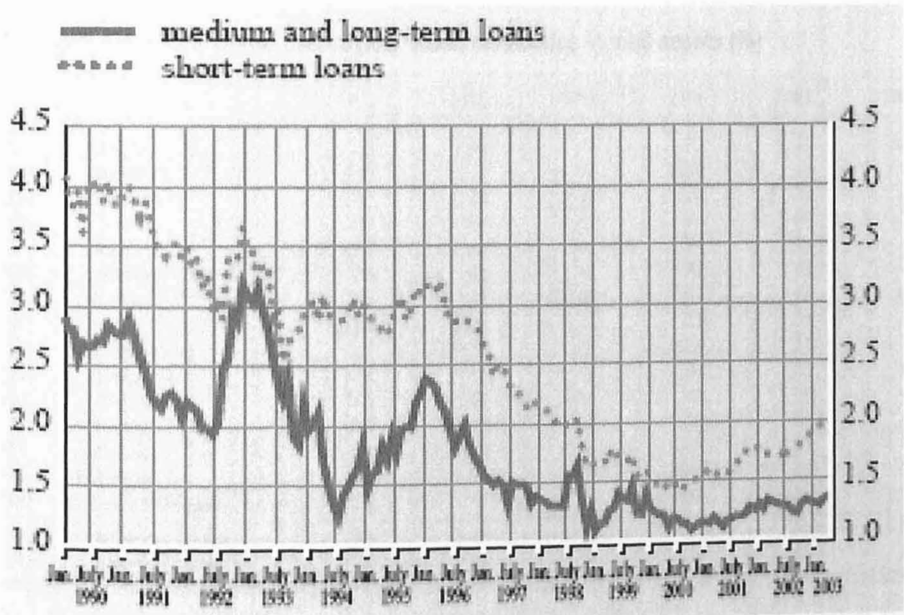
Source: Baele et al. (2004)

Appendix D: Cross-sectional standard deviation of the average overnight lending rates among euro area countries (30-day moving average, basis points).



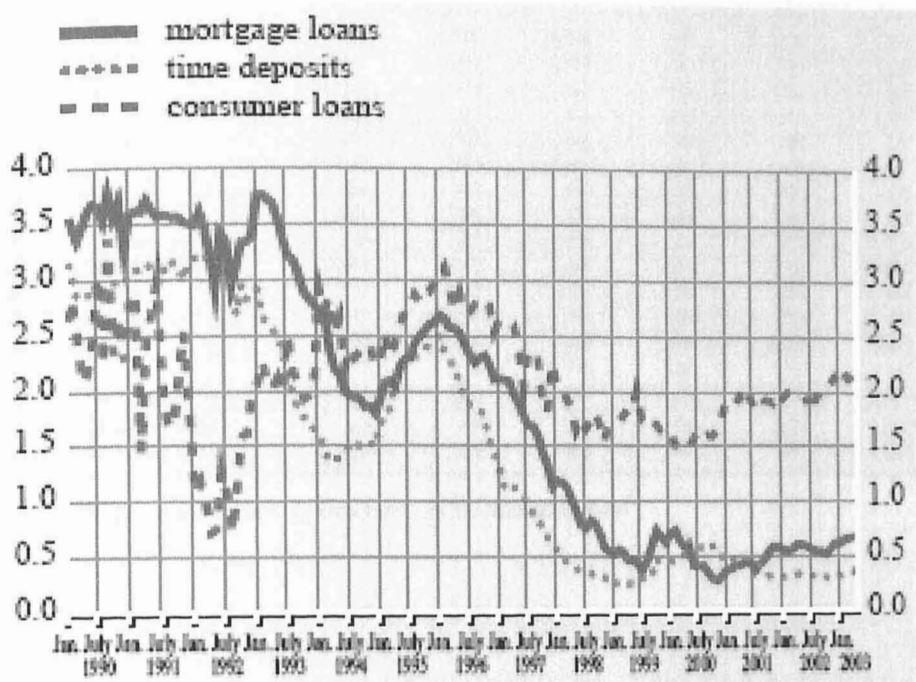
Source: Baele et al. (2004)

Appendix E: Cross-sectional standard deviation of interest rates on short-term and medium- and long-term loans to enterprises



Source: Baele et al. (2004)

Appendix F: Cross-sectional standard deviation of interest rates on consumer and mortgage loans and time deposits



Source: Baele et al. (2004)

Appendix G: Share of the five largest credit institutions in total assets (%)

Country		1997	1998	1999	2000	2001	2002	2003
BE	Belgium	54	63	76	75	78	82	83
DK	Denmark	70	71	71	60	68	68	67
DE	Germany	17	19	19	20	20	20	22
GR	Greece	56	63	67	65	67	67	67
ES	Spain	32	35	41	46	45	44	44
FR	France	40	41	43	47	47	45	47
IE	Ireland	41	40	41	41	43	46	44
IT	Italy	25	25	25	23	29	31	27
LU	Luxembourg	23	25	26	26	28	30	32
NL	Netherlands	79	82	82	81	83	83	84
AT	Austria	44	42	41	43	45	46	44
PT	Portugal	46	45	44	59	60	60	63
FI	Finland	88	86	86	87	80	79	81
SE	Sweden	58	56	56	57	55	56	54
UK	United Kingdom	24	25	28	28	29	30	33
MU12	Monetary Union	45	47	49	51	52	53	53
EU15	European Union	46	48	50	51	52	52	53

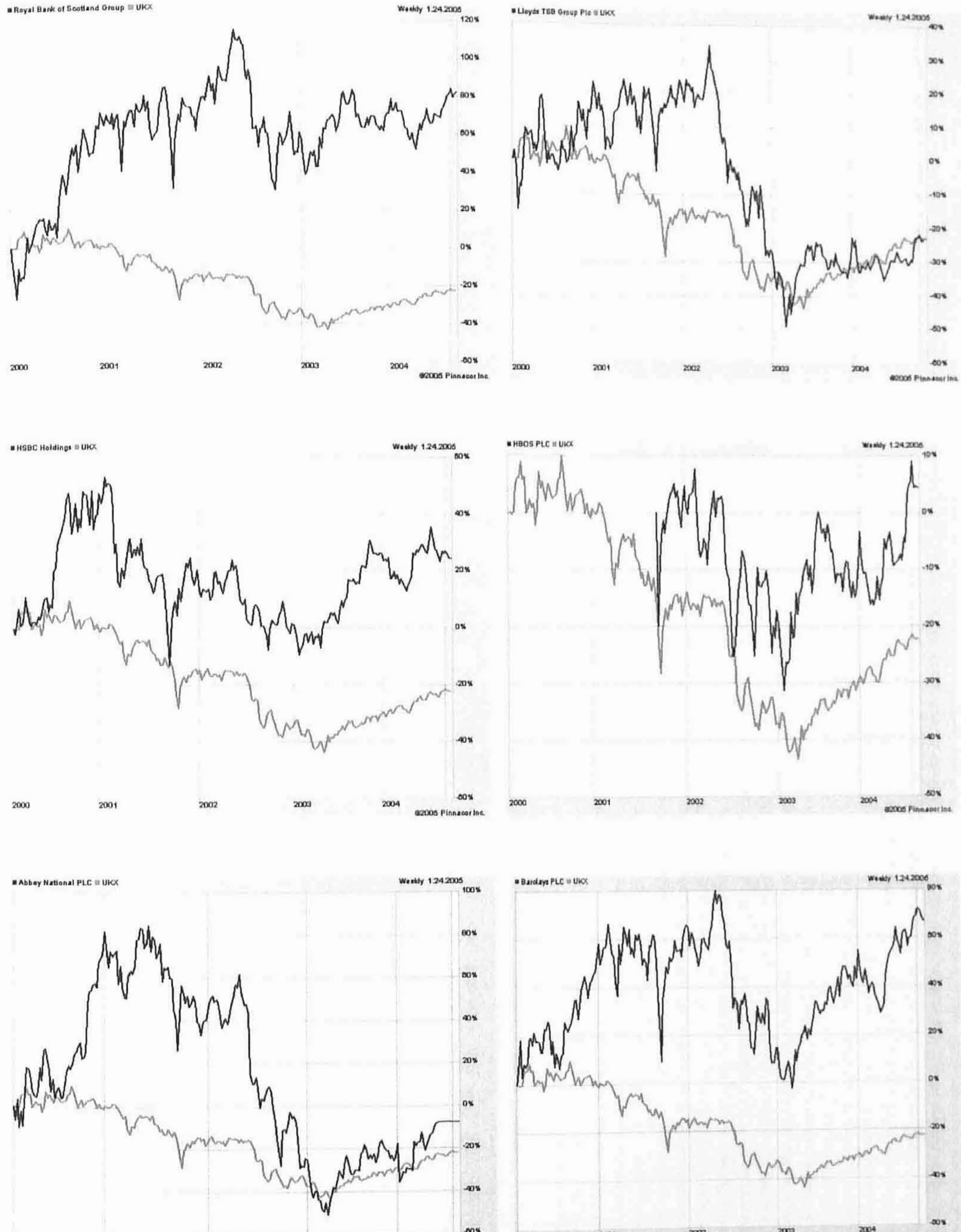
Source: "Report on EU banking structure", ECB, November 2004
Note: For Finland the chnage in 2001 is due to a reclassification

Appendix H: Herfindahl index for credit institutions total assets

Country		1997	1998	1999	2000	2001	2002	2003
BE	Belgium	699	909	1,518	1,506	1,587	1,905	2,065
DK	Denmark	1,431	1,442	1,499	863	1,119	1,145	1,114
DE	Germany	114	133	140	151	158	163	173
GR	Greece	885	1,165	986	1,122	1,113	1,164	1,130
ES	Spain	285	329	441	581	551	529	521
FR	France	449	485	509	587	606	551	597
IE	Ireland	500	473	480	486	512	553	562
IT	Italy	201	210	220	190	260	270	240
LU	Luxembourg	210	222	236	242	275	296	315
NL	Netherlands	1,654	1,802	1,700	1,694	1,762	1,788	1,744
AT	Austria	515	515	511	548	561	618	557
PT	Portugal	577	575	566	986	991	963	1,044
FI	Finland	2,150	2,120	1,960	2,050	2,240	2,050	2,420
SE	Sweden	830	790	790	800	760	800	760
UK	United Kingdom	208	221	250	264	282	307	347
MU12	Monetary Union	383	429	468	508	544	553	581
EU15	European Union	373	411	445	464	497	513	541

Source: "Report on EU banking structure", ECB, November 2004

Appendix I: Share performance of Abbey National, Barclays, HBOS, HSBC, Royal Bank of Scotland, and Lloyds in the period (2000-January 2005) compared to the FTSE 100.



Source: http://ww.hsbc.com